ACTIVISION INC /NY
Form 10-Q
February 08, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark one)

ý **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended December 31, 2004

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission File Number 0-12699

ACTIVISION, INC.

(Exact name of registrant as specified in its charter)

Delaware	**95-4803544**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3100 Ocean Park Boulevard, Santa Monica, CA	**90405**
(Address of principal executive offices)	(Zip Code)

(310) 255-2000

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ý No o

The number of shares of the registrant s Common Stock outstanding as of February 1, 2005 was 142,323,269.

ACTIVISION, INC. AND SUBSIDIARIES

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Part I. Financial Information.

Item 1. Financial Statements.

ACTIVISION, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

	December 31, 2004 (Unaudited)	March 31, 2004
Assets		
Current assets:		
Cash and cash equivalents	$ 402,530	$ 466,552
Short-term investments	310,650	121,097
Accounts receivable, net of allowances of $83,209 and $47,028 at December 31, 2004 and March 31, 2004, respectively	344,894	62,577
Inventories	41,656	26,427
Software development	61,550	58,320
Intellectual property licenses	19,908	32,115
Deferred income taxes	13,689	26,127
Other current assets	17,424	18,660
Total current assets	1,212,301	811,875
Software development	13,384	28,386
Intellectual property licenses	11,624	16,380
Property and equipment, net	26,798	25,539
Deferred income taxes		9,064
Other assets	2,530	1,080
Goodwill	77,992	76,493
Total assets	$ 1,344,629	$ 968,817
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable	$ 156,376	$ 72,874
Accrued expenses	155,057	63,205
Total current liabilities	311,433	136,079
Deferred income taxes	12,712	
Total liabilities	324,145	136,079
Commitments and contingencies (Note 13)		
Shareholders equity:		
Preferred stock, $.000001 par value, 3,750,000 shares authorized, no shares issued at December 31, 2004 and March 31, 2004		

Series A Junior Preferred stock, $.000001 par value, 1,250,000 shares authorized, no shares issued at December 31, 2004 and March 31, 2004		
Common stock, $.000001 par value, 225,000,000 shares authorized, 171,000,166 and 166,876,567 shares issued and 141,454,841 and 137,331,242 shares outstanding at December 31, 2004 and March 31, 2004, respectively		
Additional paid-in capital	803,753	758,626
Retained earnings	343,041	208,279
Less: Treasury stock, at cost, 29,545,325 and 29,545,325 shares at December 31, 2004 and March 31, 2004, respectively	(144,128)	(144,128)
Accumulated other comprehensive income	17,818	9,961
Total shareholders equity	1,020,484	832,738
Total liabilities and shareholders equity	$ 1,344,629	$ 968,817

The accompanying notes are an integral part of these consolidated financial statements.

ACTIVISION, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(In thousands, except per share data)

	For the three months ended December 31, 2004	For the three months ended December 31, 2003	For the nine months ended December 31, 2004	For the nine months ended December 31, 2003
Net revenues	$ 680,094	$ 508,511	$ 1,201,996	$ 784,759
Costs and expenses:				
Cost of sales product costs	316,494	235,301	528,759	384,302
Cost of sales software royalties and amortization	58,200	23,680	116,846	50,575
Cost of sales intellectual property licenses	22,598	9,464	57,797	27,008
Product development	25,068	50,354	66,054	79,828
Sales and marketing	105,248	58,503	200,216	102,025
General and administrative	15,407	14,248	44,854	35,847
Total costs and expenses	543,015	391,550	1,014,526	679,585
Operating income	137,079	116,961	187,470	105,174
Investment income, net	3,197	1,464	7,954	4,125
Income before income tax provision	140,276	118,425	195,424	109,299
Income tax provision	43,014	41,444	60,662	38,248
Net income	$ 97,262	$ 76,981	$ 134,762	$ 71,051
Basic earnings per share	$ 0.70	$ 0.58	$ 0.97	$ 0.54
Weighted average common shares outstanding	139,820	133,145	138,700	132,488
Diluted earnings per share	$ 0.63	$ 0.53	$ 0.87	$ 0.49
Weighted average common shares outstanding assuming dilution	155,592	146,027	154,418	143,679

The accompanying notes are an integral part of these consolidated financial statements.

ACTIVISION, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)
(In thousands)

	For the nine months ended December 31, 2004	2003
Cash flows from operating activities:		
Net income	$ 134,762	$ 71,051
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income taxes	34,214	18,626
Realized gain on short term investments	(471)	
Depreciation and amortization	7,742	7,711
Amortization and write-offs of capitalized software development costs and intellectual property licenses	125,682	76,276
Tax benefit of stock options and warrants exercised	13,802	3,567
Changes in operating assets and liabilities:		
Accounts receivable	(282,317)	(226,007)
Inventories	(15,229)	(15,929)
Software development and intellectual property licenses	(96,947)	(88,714)
Other assets	(214)	(968)
Accounts payable	83,502	125,225
Accrued expenses and other liabilities	91,852	75,496
Net cash provided by operating activities	96,378	46,334
Cash flows from investing activities:		
Capital expenditures	(8,030)	(9,455)
Purchases of short-term investments	(242,039)	(131,058)
Proceeds from sales and maturities of short-term investments	51,778	126,136
Cash payment to effect business combinations, net of cash acquired		(3,480)
Net cash used in investing activities	(198,291)	(17,857)
Cash flows from financing activities:		
Proceeds from issuance of common stock to employees	30,134	11,389
Other borrowings, net		(2,818)
Purchase of structured stock repurchase transactions		(52,621)
Settlement of structured stock repurchase transactions		166,521
Purchase of treasury stock		(19,996)
Net cash provided by financing activities	30,134	102,475
Effect of exchange rate changes on cash	7,757	8,918
Net (decrease) increase in cash and cash equivalents	(64,022)	139,870
Cash and cash equivalents at beginning of period	466,552	285,554

Cash and cash equivalents at end of period		$	402,530		$	425,424	

The accompanying notes are an integral part of these consolidated financial statements.

ACTIVISION, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

For the Nine Months ended December 31, 2004

(Unaudited)
(In thousands)

	Common Stock				**Treasury Stock**			
	Shares	**Amount**	**Additional Paid-In Capital**	**Retained Earnings**	**Shares**	**Amount**	**Accumulated Other Comprehensive Income (Loss)**	**Shareholders Equity**
Balance, March 31, 2004	**166,877**	**$**	**$ 758,626**	**$ 208,279**	**(29,546)**	**$ (144,128)**	**$ 9,961**	**$ 832,738**
Components of comprehensive income:								
Net income				134,762				134,762
Unrealized loss on short-term investments							(1,179)	(1,179)
Foreign currency translation adjustment							9,036	9,036
Total comprehensive income								142,619
Issuance of common stock pursuant to employee stock option and stock purchase plans	4,041		30,134					30,134
Issuance of stock to effect business combination	82		1,191					1,191
Tax benefit attributable to employee stock options			13,802					13,802
Balance, December 31, 2004	**171,000**	**$**	**$ 803,753**	**$ 343,041**	**(29,546)**	**$ (144,128)**	**$ 17,818**	**$ 1,020,484**

The accompanying notes are an integral part of these consolidated financial statements

ACTIVISION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

For the Three and Nine Months ended December 31, 2004

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements include the accounts of Activision, Inc. and its subsidiaries (Activision or we). The information furnished is unaudited and consists of only normal recurring adjustments that, in the opinion of management, are necessary to provide a fair statement of the results for the interim periods presented. The Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended March 31, 2004 as filed with the Securities and Exchange Commission (SEC).

Software Development Costs and Intellectual Property Licenses

Software development costs include payments made to independent software developers under development agreements, as well as direct costs incurred for internally developed products.

We account for software development costs in accordance with SFAS No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed. Software development costs are capitalized once technological feasibility of a product is established and such costs are determined to be recoverable. Technological feasibility of a product encompasses both technical design documentation and game design documentation. For products where proven technology exists, this may occur early in the development cycle. Technological feasibility is evaluated on a product-by-product basis. Prior to a product s release, we expense, as part of cost of sales software royalties and amortization, capitalized costs when we believe such amounts are not recoverable. Capitalized costs for those products that are cancelled or abandoned are charged to product development expense in the period of cancellation. Amounts related to software development which are not capitalized are charged immediately to product development expense. We evaluate the future recoverability of capitalized amounts on a quarterly basis. The recoverability of capitalized software development costs is evaluated based on the expected performance of the specific products for which the costs relate. Criteria used to evaluate expected product performance include: historical performance of comparable products using comparable technology; orders for the product prior to its release; and estimated performance of a sequel product based on the performance of the product on which the sequel is based.

Commencing upon product release, capitalized software development costs are amortized to cost of sales software royalties and amortization based on the ratio of current revenues to total projected revenues, generally resulting in an amortization period of six months or less. For products that have been released in prior periods, we evaluate the future recoverability of capitalized amounts on a quarterly basis. The primary evaluation criterion is actual title performance.

Significant management judgments and estimates are utilized in the assessment of when technological feasibility is established, as well as in the ongoing assessment of the recoverability of capitalized costs. In evaluating the recoverability of capitalized costs, the assessment of expected product performance utilizes forecasted sales amounts and estimates of additional costs to be incurred. If revised forecasted or actual product sales are less than and/or revised forecasted or actual costs are greater than the original forecasted amounts utilized in the initial recoverability analysis, the net realizable value may be lower than originally estimated in any given quarter, which could result in an impairment charge.

Intellectual property license costs represent license fees paid to intellectual property rights holders for use of their trademarks, copyrights, software, technology or other intellectual property or proprietary rights in the development of our products. Depending upon the agreement with the rights holder, we may obtain the rights to use acquired intellectual property in multiple products over multiple years, or alternatively, for a single product.

We evaluate the future recoverability of capitalized intellectual property licenses on a quarterly basis. The recoverability of capitalized intellectual property license costs is evaluated based on the expected performance of the specific products in which the licensed trademark or copyright is to be used. As many of our intellectual property licenses extend for multiple products over multiple years, we also assess the recoverability of capitalized intellectual property license costs based on certain qualitative factors such as the success of other products and/or entertainment vehicles utilizing the intellectual property, whether there are any future planned theatrical releases or television series based on the intellectual property and the rights holder s continued promotion and exploitation of the intellectual property. Prior to the related product s release, we expense, as part of cost of sales intellectual property licenses, capitalized intellectual property costs when we believe such amounts are not recoverable. Capitalized intellectual property costs for those products that are cancelled or abandoned are charged to product development expense in the period of cancellation. Criteria used to evaluate expected product performance include: historical performance of comparable products using comparable technology; orders for the product prior to its release; and estimated performance of a sequel product based on the performance of the product on which the sequel is based.

Commencing upon the related product s release, capitalized intellectual property license costs are amortized to cost of sales intellectual property licenses based on the ratio of current revenues for the specific product to total projected revenues for all products in which the licensed property will be utilized. As intellectual property license contracts may extend for multiple years, the amortization of capitalized intellectual property license costs relating to such contracts may extend beyond one year. For intellectual property included in products that have been released, we evaluate the future recoverability of capitalized amounts on a quarterly basis. The primary evaluation criterion is actual title performance.

Significant management judgments and estimates are utilized in the assessment of the recoverability of capitalized costs. In evaluating the recoverability of capitalized costs, the assessment of expected product performance utilizes forecasted sales amounts and estimates of additional costs to be incurred. If revised forecasted or actual product sales are less than, and/or revised forecasted or actual costs are greater than, the original forecasted amounts utilized in the initial recoverability analysis, the net realizable value may be lower than originally estimated in any given quarter, which could result in an impairment charge. Additionally, as noted above, as many of our intellectual property licenses extend for multiple products over multiple years, we also assess the recoverability of capitalized intellectual property license costs based on certain qualitative factors such as the success of other products and/or entertainment vehicles utilizing the intellectual property, whether there are any future planned theatrical releases or television series based on the intellectual property and the rights holder s continued promotion and exploitation of the intellectual property. Material differences may result in the amount and timing of charges for any period if management makes different judgments or utilizes different estimates in evaluating these qualitative factors.

Revenue Recognition

We recognize revenue from the sale of our products upon the transfer of title and risk of loss to our customers. Certain products are sold to customers with a street date (the date that products are made widely available by retailers). For these products we recognize revenue no earlier than the street date. Revenue from product sales is recognized after deducting the estimated allowance for returns and price protection. With respect to license agreements that provide customers the right to make multiple copies in exchange for guaranteed amounts, revenue is recognized upon delivery of such copies. Per copy royalties on sales that exceed the guarantee are recognized as earned. In addition, in order to recognize revenue for both product sales and licensing transactions, persuasive evidence of an arrangement must exist and collection of the related receivable must be probable. Revenue recognition also determines the timing of certain expenses, including cost of sales intellectual property licenses and cost of sales software royalties and amortization.

Sales incentives or other consideration given by us to our customers is accounted for in accordance with the Financial Accounting Standards Board s Emerging Issues Task Force (EITF) Issue 01-9, Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products). In accordance with EITF Issue 01-9, sales incentives and other consideration that are considered adjustments of the selling price of our products, such as rebates and product placement fees, are reflected as reductions of revenue. Sales incentives and other consideration that represent costs incurred by us for assets or services received, such as the appearance of our products in a customer s national circular ad, are reflected as sales and marketing expenses.

Stock-Based Compensation and Pro Forma Information

Under SFAS No. 123 Accounting for Stock-Based Compensation, compensation expense is recorded for the issuance of stock options and other stock-based compensation based on the fair value of the stock options and other stock-based compensation on the date of grant or measurement date. Alternatively, SFAS No. 123 allows companies to continue to account for the issuance of stock options and other stock-based compensation in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. Under APB No. 25, compensation expense is recorded for the issuance of stock options and other stock-based compensation based on the intrinsic value of the stock options and other stock-based compensation on the date of grant or measurement date. Under the intrinsic value method, compensation expense is recorded on the date of grant or measurement date only if the current market price of the underlying stock exceeds the stock option or other stock-based compensation exercise price. At December 31, 2004, we had several stock-based employee compensation plans, which are described more fully in Note 15 to the Notes to Consolidated Financial Statements included in Item 8 of our Annual Report on Form 10-K for the year ended March 31, 2004 filed with the SEC. We account for those plans under the recognition and measurement principles of APB Opinion No. 25 and related Interpretations. The following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation (amounts in thousands, except per share data):

	Three months ended December 31,		Nine months ended December 31,	
	2004	2003	2004	2003
Net income, as reported	$ 97,262	$ 76,981	$ 134,762	$ 71,051
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects		126		126
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(3,242)	(3,693)	(11,667)	(13,432)
Pro forma net income	$ 94,020	$ 73,414	$ 123,095	$ 57,745
Earnings per share:				
Basic as reported	$ 0.70	$ 0.58	$ 0.97	$ 0.54
Basic pro forma	$ 0.67	$ 0.55	$ 0.89	$ 0.44
Diluted as reported	$ 0.63	$ 0.53	$ 0.87	$ 0.49
Diluted pro forma	$ 0.60	$ 0.50	$ 0.80	$ 0.40

The fair value of options granted is estimated at the date of grant using the Black-Scholes option pricing model. The Black-Scholes option pricing model requires the input of highly subjective assumptions, including the expected stock price volatility. We use the historical stock price volatility of our common stock over the most recent period that is generally commensurate with the expected option life as the basis for estimating expected stock price volatility. For options granted in each of the quarters in the nine months ended December 31, 2004 and 2003, the historical stock price volatility used was based on a weekly stock price observation, using an average of the high and low stock prices of our common stock, which resulted in an expected stock price volatility ranging from 45% to 48% and 47% to 52%, respectively. For purposes of the above pro forma disclosure, the fair value of options granted is amortized to stock-based employee compensation cost over the period(s) in which the related employee services are rendered. Accordingly, the pro forma stock-based compensation cost for any period will typically relate to options granted in both the current period and prior periods.

2. <u>Stock Split</u>

In February 2004, the Board of Directors approved a three-for-two split of our outstanding common shares effected in the form of a 50% stock dividend. The split was paid on March 15, 2004 to shareholders of record as of February 23, 2004. The par value of our common stock was maintained at the pre-split amount of $.000001. The Consolidated Financial Statements and Notes thereto, including all share and per share data, have been restated as if the stock split had occurred as of the earliest period presented.

3. Cash, Cash Equivalents and Short-term Investments

Short-term investments generally mature between three and thirty months. Investments with maturities beyond one year may be classified as short-term based on their liquid nature and because such securities represent the investment of cash that is available for current operations. All of our short-term investments are classified as available-for-sale and are carried at fair market value with unrealized appreciation (depreciation) reported as a separate component of accumulated other comprehensive income in shareholders equity. The specific identification method is used to determine the cost of securities disposed with realized gains and losses reflected in investment income, net.

The following table summarizes our investments in securities as of December 31, 2004 (amounts in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Cash and cash equivalents:				
Cash and time deposits	$ 201,929	$	$	201,929
Money market instruments	90,362			90,362
Auction rate notes	110,239			110,239
Cash and cash equivalents	402,530			402,530
Short-term investments:				
Corporate bonds	93,081		(650)	92,431
Taxable senior debt	15,019	1		15,020
U.S. agency issues	161,854		(951)	160,903
Asset-backed securities	40,601	23	(609)	40,015
Common stock	167	1,104		1,271
Municipal bonds	1,010			1,010
Short-term investments	311,732	1,128	(2,210)	310,650
Cash, cash equivalents and short-term investments	$ 714,262	$ 1,128	$ (2,210)	$ 713,180

The following table summarizes the maturities of our investments in debt securities as of December 31, 2004 (amounts in thousands):

	Amortized Cost	Fair Value
Due in one year or less	$ 271,182	$ 270,405
Due after one year through thirty months	110,021	109,198
	381,203	379,603
Asset-backed securities	40,601	40,015
Total	$ 421,804	$ 419,618

For the three months ended December 31, 2004, there were no gross realized gains or losses on short-term investments. For the nine months ended December 31, 2004, net realized gains on short-term investments consisted of $471,000 of gross realized gains and no gross realized losses.

For the three months ended December 31, 2003, net realized gains on short-term investments consisted of $1,000 of gross realized gains and no gross realized losses. For the nine months ended December 31, 2003, net realized gains on short-term investments consisted of $21,000 of gross realized gains and $4,000 of gross realized losses.

4. **Inventories**

Inventories are valued at the lower of cost (first-in, first-out) or market. Our inventories consist of the following (amounts in thousands):

	December 31, 2004	March 31, 2004
Purchased parts and components	$ 1,224	$ 392
Finished goods	40,432	26,035
	$ 41,656	$ 26,427

5. **Goodwill and Other Intangible Assets**

The changes in the carrying amount of goodwill for the nine months ended December 31, 2004 are as follows (amounts in thousands):

	Publishing	Distribution	Total
Balance as of March 31, 2004	$ 70,898	$ 5,595	$ 76,493
Adjustment to original purchase allocation	1,191		1,191
Effect of foreign currency exchange rates		308	308
Balance as of December 31, 2004	$ 72,089	$ 5,903	$ 77,992

6. **Income Taxes**

The income tax provision of $43.0 million and $60.7 million for the three and nine months ended December 31, 2004, respectively, reflect our effective income tax rate of approximately 31%. The significant items that generated the variance between our effective rate and our statutory rate of 35% were research and development tax credits and the impact of foreign tax rate differentials, partially offset by state taxes. The income tax provision of $41.4 million and $38.2 million for the three and nine months ended December 31, 2003, respectively, reflect our effective income tax rate of approximately 35%. The significant items that generated variances between our effective rate and our statutory rate of 35% were state taxes, offset by research and development tax credits.

7. **Software Development Costs and Intellectual Property Licenses**

As of December 31, 2004, capitalized software development costs included $39.9 million of internally developed software costs and $35.1 million of payments made to third-party software developers. As of March 31, 2004, capitalized software development costs included $35.3 million of internally developed software costs and $51.5 million of payments made to third-party software developers. Capitalized intellectual property licenses were $31.5 million and $48.5 million as of December 31, 2004 and March 31, 2004, respectively. Amortization and write-offs of capitalized software development costs and intellectual property licenses were $125.7 million and $76.3 million for the nine months ended December 31, 2004 and 2003, respectively.

During the three months ended December 31, 2003, we completed a comprehensive review of our product portfolio in which we evaluated each product based on a number of criteria, including: the strength of the franchise, the projected product quality, the potential responsiveness of the product to aggressive marketing support and the financial risk in the event of product failure. As a result of this review at the time, we found that we had an extensive slate of high-potential properties in development. However, we also found that certain projects had a lower likelihood of achieving acceptable levels of operating performance and that continued pursuit of these projects would create a substantial opportunity cost as it related to our slate of high-potential projects. Accordingly, in the three months ended December 31, 2003, we canceled the development of ten products which we believed were unlikely to produce an acceptable level of return on our investment. In connection with the cancellation of these products, we recorded a pre-tax charge of approximately $21 million in the quarter ended December 31, 2003 which is included in the consolidated statement of operations in product development expense.

8. Comprehensive Income and Accumulated Other Comprehensive Income

Comprehensive Income

The components of comprehensive income for the three and nine months ended December 31, 2004 and 2003 were as follows (amounts in thousands):

	Three months ended December 31,		Nine months ended December 31,	
	2004	2003	2004	2003
Net income	$ 97,262	$ 76,981	$ 134,762	$ 71,051
Other comprehensive income:				
Foreign currency forward contracts		(458)		(458)
Foreign currency translation adjustment	10,488	6,778	9,036	11,399
Unrealized depreciation on short-term investments	(1,509)	(38)	(1,179)	(52)
Other comprehensive income	8,979	6,282	7,857	10,889
Comprehensive income	$ 106,241	$ 83,263	$ 142,619	$ 81,940

Accumulated Other Comprehensive Income

The components of accumulated other comprehensive income were as follows (amounts in thousands):

	Foreign Currency Translation Adjustment	Unrealized Appreciation (Depreciation) on Investments	Accumulated Other Comprehensive Income (Loss)
Balance, March 31, 2004	$ 9,864	$ 97	$ 9,961
Other comprehensive income (loss)	9,036	(1,179)	7,857
Balance, December 31, 2004	$ 18,900	$ (1,082)	$ 17,818

The income taxes related to unrealized appreciation (depreciation) on investments were not significant. Income taxes were not provided for foreign currency translation items as these are considered indefinite investments in non-U.S. subsidiaries.

9. Investment Income, Net

Investment income, net is comprised of the following (amounts in thousands):

	Three months ended December 31,		Nine months ended December 31,	
	2004	2003	2004	2003
Interest expense	$ (61)	$ (43)	$ (207)	$ (285)
Interest income	3,258	1,506	7,690	4,393
Net realized gain on investments		1	471	17
Investment income, net	$ 3,197	$ 1,464	$ 7,954	$ 4,125

10. Supplemental Cash Flow Information

Non-cash investing and financing activities and supplemental cash flow information is as follows (amounts in thousands):

	Nine months ended December 31,	
	2004	2003
Non-cash investing and financing activities:		
Issuance of options and common stock warrants	$	$ 377
Issuance of stock to effect business combination	1,191	
Change in unrealized depreciation on short-term investments	1,179	52
Supplemental cash flow information:		
Cash paid for income taxes	$ 8,678	$ 7,156
Cash received for interest, net	6,489	4,276

11. Operations by Reportable Segments and Geographic Area

Based upon our organizational structure, we operate two business segments: (i) publishing of interactive entertainment software and (ii) distribution of interactive entertainment software and hardware products.

Publishing refers to the development, marketing and sale of products, either directly, by license or through our affiliate label program with certain third-party publishers. In the United States, we primarily sell our products on a direct basis to mass-market retailers, consumer electronics stores, discount warehouses and game specialty stores. We conduct our international publishing activities through offices in the United Kingdom, Germany, France, Italy, Spain, Australia, Sweden, Canada and Japan. Our products are sold internationally on a direct-to-retail basis and through third-party distribution and licensing arrangements and through our wholly-owned distribution subsidiaries.

Distribution refers to our operations in the United Kingdom, the Netherlands and Germany that provide logistical and sales services to third-party publishers of interactive entertainment software, our own publishing operations and manufacturers of interactive entertainment hardware.

Resources are allocated to each of these segments using information on their respective net revenues and operating profits before interest and taxes.

The accounting policies of these segments are the same as those described in the Summary of Significant Accounting Policies in our Annual Report on Form 10-K for the year ended March 31, 2004. Revenue derived from sales between segments is eliminated in consolidation.

Information on the reportable segments for the three and nine months ended December 31, 2004 and 2003 is as follows (amounts in thousands):

	Three months ended December 31, 2004		
	Publishing	Distribution	Total
Total segment revenues	$ 514,053	$ 166,041	$ 680,094
Revenues from sales between segments	(51,408)	51,408	
Revenues from external customers	$ 462,645	$ 217,449	$ 680,094
Operating income	$ 120,608	$ 16,471	$ 137,079
Total assets	$ 1,149,736	$ 194,893	$ 1,344,629

13

	Three months ended December 31, 2003		
	Publishing	Distribution	Total
Total segment revenues	$ 382,921	$ 125,590	$ 508,511
Revenues from sales between segments	(48,801)	48,801	
Revenues from external customers	$ 334,120	$ 174,391	$ 508,511
Operating income	$ 104,964	$ 11,997	$ 116,961
Total assets	$ 883,298	$ 217,993	$ 1,101,291

	Nine months ended December 31, 2004		
	Publishing	Distribution	Total
Total segment revenues	$ 942,100	$ 259,896	$ 1,201,996
Revenues from sales between segments	(92,186)	92,186	
Revenues from external customers	$ 849,914	$ 352,082	$ 1,201,996
Operating income	$ 168,111	$ 19,359	$ 187,470
Total assets	$ 1,149,736	$ 194,893	$ 1,344,629

	Nine months ended December 31, 2003		
	Publishing	Distribution	Total
Total segment revenues	$ 569,122	$ 215,637	$ 784,759
Revenues from sales between segments	(63,005)	63,005	
Revenues from external customers	$ 506,117	$ 278,642	$ 784,759
Operating income	$ 93,240	$ 11,934	$ 105,174
Total assets	$ 883,298	$ 217,993	$ 1,101,291

Geographic information for the three and nine months ended December 31, 2004 and 2003 is based on the location of the selling entity. Revenues from external customers by geographic region were as follows (amounts in thousands):

	Three months ended December 31,		Nine months ended December 31,	
	2004	2003	2004	2003
United States	$ 344,342	$ 252,114	$ 627,238	$ 381,303
Europe	324,360	246,919	543,480	385,952
Other	11,392	9,478	31,278	17,504
Total	$ 680,094	$ 508,511	$ 1,201,996	$ 784,759

Revenues by platform were as follows (amounts in thousands):

	Three months ended December 31,		Nine months ended December 31,	
	2004	2003	2004	2003
Console	$ 516,903	$ 407,975	$ 850,695	$ 611,008
Hand-held	71,166	20,284	120,476	36,709
PC	92,025	80,252	230,825	137,042
Total	$ 680,094	$ 508,511	$ 1,201,996	$ 784,759

As of and for the three and nine months ended December 31, 2004, we had one customer that accounted for 22% of consolidated net revenues in each period and 32% of consolidated accounts receivable, net. As of and for the three and nine months ended December 31, 2003, we had one customer that accounted for 19% and 18% of consolidated net revenues, respectively, and 32% of consolidated accounts receivable, net. This customer was the same customer in all periods and was a customer of both our publishing and distribution businesses.

12. <u>Computation of Earnings Per Share</u>

The following table sets forth the computations of basic and diluted earnings per share (amounts in thousands, except per share data):

	Three months ended December 31,		Nine months ended December 31,	
	2004	2003	2004	2003
Numerator:				
Numerator for basic and diluted earnings per share income available to common shareholders	$ 97,262	$ 76,981	$ 134,762	$ 71,051
Denominator:				
Denominator for basic earnings per share-weighted average common shares outstanding	139,820	133,145	138,700	132,488
Effect of dilutive securities:				
Employee stock options and stock purchase plan	15,056	12,345	15,036	10,698
Warrants to purchase common stock	716	537	682	493
Potential dilutive common shares	15,772	12,882	15,718	11,191
Denominator for diluted earnings per share - weighted average common shares outstanding plus assumed conversions	155,592	146,027	154,418	143,679
Basic earnings per share	$ 0.70	$ 0.58	$ 0.97	$ 0.54
Diluted earnings per share	$ 0.63	$ 0.53	$ 0.87	$ 0.49

Options to purchase 115,659 shares of common stock at exercise prices ranging from $15.55 to $19.38 and options to purchase 1,497,602 shares of common stock at exercise prices ranging from $14.92 to $19.38 were outstanding for the three and nine months ended December 31, 2004, respectively, but were not included in the calculation of diluted earnings per share because their effect would be antidilutive.

Options to purchase 8,868,879 shares of common stock at exercise prices ranging from $12.14 to $14.77 and options to purchase 10,423,838 shares of common stock at exercise prices ranging from $12.14 to $14.77 were

outstanding for the three and nine months ended December 31, 2003, respectively, but were not included in the calculation of diluted earnings per share because their effect would be antidilutive.

13. Commitments and Contingencies

Credit Facilities

We have revolving credit facilities with our Centresoft subsidiary located in the United Kingdom (the UK Facility) and our NBG subsidiary located in Germany (the German Facility). As of December 31, 2004, the UK Facility provided Centresoft with the ability to borrow up to Great Britain Pounds (GBP) 8.0 million ($15.4 million), including issuing letters of credit, on a revolving basis. Furthermore, as of December 31, 2004, under the UK Facility, Centresoft provided a GBP 0.6 million ($1.2 million) guarantee for the benefit of our CD Contact subsidiary. The UK Facility bears interest at LIBOR plus 2.0%, is collateralized by substantially all of the assets of the subsidiary and expires in November 2005. The UK Facility also contains various covenants that require the subsidiary to maintain specified financial ratios related to, among others, fixed charges. As of December 31, 2004, we were in compliance with these covenants. No borrowings were outstanding against the UK Facility as of December 31, 2004. The German Facility provided for revolving loans up to EUR 0.5 million ($0.7 million) as of December 31, 2004, bears interest at a Eurocurrency rate plus 2.5%, is collateralized by certain of the subsidiary s property and equipment and has no expiration date. No borrowings were outstanding against the German Facility as of December 31, 2004.

Developer and Intellectual Property Contracts

In the normal course of business, we enter into contractual arrangements with third parties for the development of products, as well as for the rights to intellectual property. Under these agreements, we commit to provide specified payments to a developer or intellectual property holder based upon contractual arrangements. Assuming all contractual provisions are met, the total future minimum contract commitment for contracts in place as of December 31, 2004 is approximately $59.0 million and is scheduled to be paid as follows (amounts in thousands):

Fiscal year ending March 31,		
2005	$	18,163
2006		24,226
2007		7,975
2008		5,775
2009 and thereafter		2,900
Total	$	59,039

The commitment schedule above excludes approximately $9.3 million of commitments originally scheduled to be paid between fiscal 2004 through fiscal 2007 relating to an intellectual property rights agreement with a third party. Effective June 30, 2003, we terminated the agreement and filed a breach of contract suit against the third party.

Marketing Commitments

In connection with certain intellectual property right acquisitions and development agreements, we will commit to spend specified amounts for marketing support for the related game(s) which is to be developed or in which the intellectual property will be utilized. Assuming all contractual provisions are met, the total future minimum marketing commitment for contracts in place as of December 31, 2004 is approximately $24.9 million, which is scheduled to be paid as follows (amounts in thousands):

Fiscal Year ending March 31,		
2005	$	1,000
2006		13,949
2007		5,000
2008		5,000
Total	$	24,949

Lease Obligations

We lease certain of our facilities under non-cancelable operating lease agreements. Total future minimum lease commitments as of December 31, 2004 are as follows (amounts in thousands):

Fiscal Year ending March 31,		
2005	$	3,053
2006		11,028
2007		10,282
2008		7,468
2009		6,671
Thereafter		31,412
Total	$	69,914

Legal and Regulatory Proceedings

On March 5, 2004, a class action lawsuit was filed against us and certain of our current and former officers and directors. The complaint, which asserts claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 based on allegations that our revenues and assets were overstated during the period between February 1, 2001 and December 17, 2002, was filed in the United States District Court, Central District of California by the Construction Industry and Carpenters Joint Pension Trust for Southern Nevada purporting to represent a class of purchasers of Activision stock. Five additional purported class actions have subsequently been filed by Gianni Angeloni, Christopher Hinton, Stephen Anish, the Alaska Electrical Pension Fund, and Joseph A. Romans asserting similar claims. Five of the six actions have been transferred to the same court where the first-filed complaint was pending. In addition, on March 12, 2004, a shareholder derivative lawsuit was filed which asserts the same claims set forth in the federal class action lawsuit. That complaint was filed in Superior Court for the County of Los Angeles. We strongly deny these allegations and will vigorously defend these cases.

On July 11, 2003, we were informed by the staff of the Securities and Exchange Commission that the Securities and Exchange Commission has commenced a non-public formal investigation captioned In the Matter of Certain Video Game Manufacturers and Distributors. The investigation appears to be focused on certain accounting practices common to the interactive entertainment industry, with specific emphasis on revenue recognition. In connection with this inquiry, the Securities and Exchange Commission submitted to us a request for information. We responded to this inquiry on September 2, 2003. To date, we have not received a request from the Securities and Exchange Commission for any additional information. The Securities and Exchange

Commission staff also informed us that other companies in the video game industry received similar requests for information. The Securities and Exchange Commission has advised us that this request for information should not be construed as an indication from the Securities and Exchange Commission or its staff that any violation of the law has occurred, nor should it reflect negatively on any person, entity or security. We have cooperated and intend to continue to cooperate fully with the Securities and Exchange Commission in the conduct of this inquiry.

On June 30, 2003, we terminated our Star Trek Merchandising License Agreement with Viacom Consumer Products, Inc. and filed a complaint in the Superior Court of the State of California for breach of contract and constructive trust against Viacom Consumer Products and Viacom International, Inc. (Viacom). On August 15, 2003, Viacom filed its response to our complaint as well as a cross-complaint alleging, among other matters, a breach of contract by Activision and seeking claimed damages in excess of $50 million. We strongly dispute the claims by Viacom, consider the damages alleged by Viacom to be speculative and without merit, and intend to defend vigorously and aggressively against the cross-complaint.

In addition, we are party to other routine claims and suits brought by us and against us in the ordinary course of business, including disputes arising over the ownership of intellectual property rights, contractual claims and collection matters. In the opinion of management, after consultation with legal counsel, the outcome of such routine claims will not have a material adverse effect on our business, financial condition, results of operations or liquidity.

14. Capital Transactions

During fiscal 2003, our Board of Directors authorized a buyback program under which we can repurchase up to $350.0 million of our common stock of which $123.5 million has been repurchased to date. Under the program, shares may be purchased as determined by management and within certain guidelines, from time to time, in the open market or in privately negotiated transactions, including privately negotiated structured option transactions, and through transactions in the options markets. Depending on market conditions and other factors, these purchases may be commenced or suspended at any time or from time to time without prior notice.

During the three months ended December 31, 2004, we did not repurchase any of our common stock or enter into any structured stock repurchase transactions. As of December 31, 2004, we had no outstanding structured stock repurchase transactions.

15. Related Parties

In August 2001, we elected to our Board of Directors an individual who is a partner in a law firm that has provided legal services to Activision for more than ten years. For the three and nine months ended December 31, 2004 and 2003, the fees we paid to the law firm were an insignificant portion of the firm s total revenues. We believe that the fees charged to us by the law firm are competitive with the fees charged by other law firms.

16. Recently Issued Accounting Standards and Laws

On December 15, 2004, the Financial Accounting Standards Board (FASB) released its final revised standard entitled FASB Statement No. 123R, *Share-Based Payment* (SFAS No. 123R). SFAS No. 123R requires that a public entity measure the cost of equity based service awards based on the grant date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award or the requisite service period. SFAS No. 123R is effective as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. We are currently assessing the impact SFAS No. 123R will have on our financial position and results of operations.

On November 24, 2004, the FASB issued Statement No. 151, *Inventory Costs, an Amendment of ARB No. 43, Chapter 4* (SFAS No. 151). The standard requires that abnormal amounts of idle capacity and spoilage costs within inventory should be excluded from the cost of inventory and expensed when incurred. The provisions of SFAS No. 151 are applicable to inventory costs incurred during fiscal years beginning after June 15, 2005. The Company expects the adoption of SFAS No. 151 will not have a material impact on our financial position or results of operations.

On December 15, 2004 the FASB issued Statement No. 153 (SFAS No. 153), *Exchanges of Nonmonetary Assets an Amendment of Accounting Principles Board Opinion No. 29*. This standard requires exchanges of productive assets to be accounted for at fair value, rather than at carryover basis, unless (1) neither the asset received nor the asset surrendered has a fair value that is determinable within reasonable limits or (2) the transactions lack commercial substance. The new standard is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The Company expects the adoption of SFAS No. 153 will not have a material impact on our financial position or results of operations.

On October 22, 2004, the President signed the American Jobs Creation Act of 2004 (the Act). The Act raises a number of issues with respect to accounting for income taxes. For companies that pay U.S. income taxes on manufacturing activities in the U.S., the Act provides a deduction from taxable income equal to a stipulated percentage of qualified income from domestic production activities. The manufacturing deduction provided by the Act replaces the extraterritorial income (ETI) deduction currently in place. We currently derive benefits from the ETI exclusion which was repealed by the Act. Our exclusion for fiscal 2005, 2006, and 2007 will be limited to 95%, 75%, and 45% of the otherwise allowable exclusion and no exclusion will be available in fiscal 2008 and thereafter. The Act also creates a temporary incentive for U.S. multinationals to repatriate accumulated income earned abroad by providing an 85 percent dividends received deduction for certain dividends from controlled foreign corporations. The deduction is subject to a number of limitations. The Act also provides for other changes in tax law that will affect a variety of taxpayers. On December 21, 2004, the Financial Accounting Standards Board (FASB) issued two FASB Staff Positions (FSP) regarding the accounting implications of the Act related to (1) the deduction for qualified domestic production activities and (2) the one-time tax benefit for the repatriation of foreign earnings. The FASB decided that the deduction for qualified domestic production activities should be accounted for as a special deduction under FASB Statement No. 109, *Accounting for Income Taxes*. The FASB also confirmed, that upon deciding that some amount of earnings will be repatriated, a company must record in that period the associated tax liability. The guidance in the FSPs applies to financial statements for periods ending after the date the Act was enacted. We are evaluating the Act at this time and have not yet determined whether we will avail ourselves of this opportunity. We plan to complete our assessment before the end of fiscal 2006 and are not currently in a position to estimate a range of possible repatriation amounts.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Overview

Our Business

We are a leading international publisher of interactive entertainment software products. We have built a company with a diverse portfolio of products that spans a wide range of categories and target markets and that is used on a variety of game hardware platforms and operating systems. We have created, licensed and acquired a group of highly recognizable brands, which we market to a variety of consumer demographics.

Our products cover game categories such as action/adventure, action sports, racing, role-playing, simulation, first-person action and strategy. Our target customer base ranges from game enthusiasts and children to mass-market consumers and value buyers. We currently offer our products primarily in versions that operate on the Sony PlayStation 2 (PS2), Nintendo GameCube (GameCube) and Microsoft Xbox (Xbox) console systems, Nintendo Game Boy Advance (GBA) and Nintendo Dual Screen (NDS) hand-held devices, and the personal computer (PC). The installed base for this current-generation of hardware platforms is significant and growing. We believe price cuts in calendar 2004 on the Xbox, PS2, GameCube, and GBA hardware, a redesign of the PS2, and the launch of the NDS should continue to drive the growth of the installed base of the current-generation platforms. In addition, Sony has announced that it would be entering the hand-held hardware market with the introduction of its hand-held gaming device, PlayStation Portable (PSP). We are currently developing titles based on the Spider-Man and Tony Hawk franchises for the PSP with the objective of having both ready for release at the launch of the PSP. We are also developing titles for the next-generation console systems being developed by Sony, Microsoft and Nintendo for release within the next one to two years. Though there are still many unknowns relating to these new platforms, our aim is to have a meaningful launch presence for all new hardware systems with a goal of gaining market share on each platform while continuing to exploit our products on the current-generation platforms given their large and growing installed base.

Our publishing business involves the development, marketing and sale of products directly by us, by license or through our affiliate label program with certain third-party publishers. In the United States, we primarily sell our products on a direct basis to mass-market retailers, consumer electronics stores, discount warehouses and game specialty stores. We conduct our international publishing activities through offices in the United Kingdom (UK), Germany, France, Italy, Spain, Australia, Sweden, Canada and Japan. Our products are sold internationally on a direct-to-retail basis, through third-party distribution and licensing arrangements and through our wholly-owned European distribution subsidiaries. Our distribution business consists of operations located in the UK, the Netherlands and Germany that provide logistical and sales services to third-party publishers of interactive entertainment software, our own publishing operations and manufacturers of interactive entertainment hardware.

Our profitability is directly affected by the mix of revenues from our publishing and distribution businesses. Operating margins realized from our publishing business are substantially higher than margins realized from our distribution business. Operating margins in our publishing business are affected by our ability to release highly successful or hit titles. Though many of these titles have substantial production or acquisition costs and marketing budgets, once a title recoups these costs, incremental net revenues directly and positively impact our operating margin. Operating margins in our distribution business are affected by the mix of hardware and software sales, with software producing higher margins than hardware.

Our Focus

With respect to future game development, we will continue to focus on our big proposition titles that are backed by strong brands and high quality development, for which we will provide significant marketing support.

A number of our fiscal 2005 big proposition titles include well-established brands, which are backed by high profile intellectual property and/or highly anticipated motion picture releases. Examples of these brands are our superheroes and skateboarding brands. We have a long-term relationship with Marvel Enterprises through an exclusive licensing agreement. This agreement grants us the exclusive rights to develop and publish video games based on Marvel s comic book franchises Spider-Man, X-Men, Fantastic Four and Iron Man. Through our long-term relationship with Spider-Man Merchandising, LLP, in the first quarter of fiscal 2005 we released the video game Spider-Man 2, the sequel to the highly successful Spider-Man: The Movie. The video game release of Spider-Man 2 coincided with the Spider-Man 2 theatrical release in June 2004. Also, under our licensing agreement with Spider-Man Merchandising, LLP, we will be developing and publishing video games based on Columbia Pictures/Marvel Enterprises, Inc. s upcoming feature film Spider-Man 3, which is expected to be released in May 2007. We also have an exclusive licensing agreement with professional skateboarder Tony Hawk. The agreement grants us exclusive rights to develop and publish video games using Tony Hawk s name and his likeness. Through fiscal 2005, we released six successful titles in the Tony Hawk franchise with cumulative net revenues of $947.5 million,

including the most recent, *Tony Hawk s Underground 2 (THUG 2)*, which was released in the third quarter of fiscal 2005.

We also continue to develop a number of original intellectual properties. In the third quarter we released the highly successful *Call of Duty: Finest Hour*, on multiple console platforms. This title was ranked by NPD Funworld (NPD) as one of the top-five best selling games for December 2004 and was the third game based upon this original property following the *Call of Duty* and *Call of Duty: United Offensive* titles for the PC. *True Crime: Streets of L.A.* is another title based upon original intellectual property and was released in the third quarter of fiscal 2004. This highly successful title was ranked by third-party sales tracking agencies, such as NPD, as among the top-five selling games for the 2003 holiday season. We expect to develop a variety of games on multiple platforms based on these two original properties and hope to establish them as a source of recurring revenues.

We will also continue to evaluate and exploit emerging brands that we believe have potential to become successful game franchises. For example, we have a multi-year, multi-property, publishing agreement with DreamWorks Animation SKG that granted us the exclusive rights to publish video games based on DreamWorks Animation SKG s theatrical release Shrek 2, which was released in the first quarter of fiscal 2005, Shark Tale , which was released in the second quarter of fiscal 2005, as well as upcoming computer-animated films, Madagascar and Over the Hedge, and their sequels. We also have an exclusive licensing agreement to develop and publish video games for the best-selling children s book series, Lemony Snicket s A Series of Unfortunate Events . In the third quarter of the current fiscal year, we released a video game of the same title to coincide with the release of the feature film by Paramount Pictures, Nickelodeon Movies and DreamWorks SKG.

In addition to acquiring or creating high profile intellectual property, we have also continued our focus on establishing and maintaining relationships with talented and experienced software development teams. We have strengthened our internal development capabilities through the acquisition of a number of development companies with talented and experienced teams including, most recently, the acquisition of Vicarious Visions Inc., a leading game development studio, in January 2005. We have development agreements with other top-level, third-party developers such as id Software, Lionhead Studios and The Creative Assembly.

We are utilizing these developer relationships, new intellectual property acquisitions, new original intellectual property creations and our existing library of intellectual property to further focus our game development on product lines that will deliver significant, lasting and recurring revenues and operating profits.

Critical Accounting Policies

We have identified the policies below as critical to our business operations and the understanding of our financial results. The impact and any associated risks related to these policies on our business operations is discussed throughout Management s Discussion and Analysis of Financial Condition and Results of Operations where such policies affect our reported and expected financial results. For a detailed discussion on the application of these and other accounting policies, see Note 1 to the Notes to the Consolidated Financial Statements included in Item 8 of our Annual Report on Form 10-K for the year ended March 31, 2004 filed with the SEC. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenue Recognition. We recognize revenue from the sale of our products upon the transfer of title and risk of loss to our customers. Certain products are sold to customers with a street date (the date that products are made widely available for sale by retailers). For these products we recognize revenue no earlier than the street date. Revenue from product sales is recognized after deducting the estimated allowance for returns and price protection. With respect to license agreements that provide customers the right to make multiple copies in exchange for guaranteed amounts, revenue is recognized upon delivery of such copies. Per copy royalties on sales that exceed the guarantee are recognized as earned. In addition, in order to recognize revenue for both product sales and licensing transactions, persuasive evidence of an arrangement must exist and collection of the related receivable must be probable. Revenue recognition also determines the timing of certain expenses, including cost of sales intellectual property licenses and cost of sales software royalties and amortization.

Allowances for Returns, Price Protection, Doubtful Accounts and Inventory Obsolescence. In determining the appropriate unit shipments to our customers, we benchmark our titles using historical and industry data. We closely monitor and analyze the historical performance of our various titles, the performance of products released by other publishers and the anticipated timing of other releases in order to assess future demands of current and upcoming titles. Initial volumes shipped upon title launch and subsequent reorders are evaluated to ensure that quantities are sufficient to meet the demands from the retail markets but at the same time, are controlled to prevent excess inventory in the channel.

We may permit product returns from, or grant price protection to, our customers under certain conditions. In general, price protection refers to the circumstances when we elect to decrease the wholesale price of a product by a certain amount and, when granted and applicable, allows customers a credit against amounts owed by such customers to Activision with respect to open and/or future invoices. The conditions our customers must meet to be granted the right to return products or price protection are, among other things, compliance with applicable payment terms, delivery to us of weekly inventory and sell-through reports, and consistent participation in the launches of our premium title releases. We may also consider other factors, including the facilitation of slow-moving inventory and other market factors. Management must make estimates of potential future product returns and price protection related to current period product revenue. We estimate the amount of future returns and price protection for current period product revenue utilizing historical experience and information regarding inventory levels and the demand and acceptance of our products by the end consumer. The following factors are used to estimate the amount of future returns and price protection for a particular title: historical performance of titles in similar genres, historical performance of the hardware platform, historical performance of the brand, console hardware life cycle, Activision sales force and retail customer feedback, industry pricing, weeks of on-hand retail channel inventory, absolute quantity of on-hand retail channel inventory, Activision warehouse on-hand inventory levels, the title s recent sell-through history (if available), marketing trade programs and competing titles. The relative importance of these factors varies among titles depending upon, among other items, genre, platform, seasonality and sales strategy. Significant management judgments and estimates must be made and used in connection with establishing the allowance for returns and price protection in any accounting period. Based upon historical experience we believe our estimates are reasonable. However, actual returns and price protection could vary materially from our allowance estimates due to a number of reasons including, among others, a lack of consumer acceptance of a title, the release in the same period of a similarly themed title by a competitor, or technological obsolescence due to the emergence of new hardware platforms. Material differences may result in the amount and timing of our revenue for any period if management makes different judgments or utilizes different estimates in determining the allowances for returns and price protection.

Similarly, management must make estimates of the uncollectibility of our accounts receivable. In estimating the allowance for doubtful accounts, we analyze the age of current outstanding account balances, historical bad debts, customer concentrations, customer creditworthiness, current economic trends and changes in our customers payment terms and their economic condition, as well as whether we can obtain sufficient credit insurance. Any significant changes in any of these criteria would impact management s estimates in establishing our allowance for doubtful accounts.

We value inventory at the lower of cost or market. We regularly review inventory quantities on hand and in the retail channel and record a provision for excess or obsolete inventory based on the future expected demand for our products. Significant changes in demand for our products would impact management s estimates in establishing our inventory provision.

Software Development Costs. Software development costs include payments made to independent software developers under development agreements, as well as direct costs incurred for internally developed products.

We account for software development costs in accordance with Statement of Financial Accounting Standard (SFAS) No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed. Software development costs are capitalized once technological feasibility of a product is established and such costs are determined to be recoverable. Technological feasibility of a product encompasses both technical design documentation and game design documentation. For products where proven technology exists, this may occur early in the development cycle. Technological feasibility is evaluated on a product-by-product basis. Prior to a product s release, we expense, as part of cost of sales software royalties and amortization, capitalized costs when we believe such amounts are not recoverable. Capitalized costs for those products that are cancelled or abandoned are charged to product development expense in the period of cancellation. Amounts related to software development which are not capitalized are charged immediately to product development expense. We evaluate the future recoverability of capitalized amounts on a quarterly basis. The recoverability of capitalized software development costs is evaluated based on the expected performance of the specific products for which the costs relate. Criteria used to evaluate expected product performance include: historical performance of comparable products using comparable technology; orders for the product prior to its release; and estimated performance of a sequel product based on the performance of the product on which the sequel is based.

Commencing upon product release, capitalized software development costs are amortized to cost of sales software royalties and amortization based on the ratio of current revenues to total projected revenues, generally resulting in an amortization period of six months or less. For products that have been released in prior periods, we

evaluate the future recoverability of capitalized amounts on a quarterly basis. The primary evaluation criterion is actual title performance.

Significant management judgments and estimates are utilized in the assessment of when technological feasibility is established, as well as in the ongoing assessment of the recoverability of capitalized costs. In evaluating the recoverability of capitalized costs, the assessment of expected product performance utilizes forecasted sales amounts and estimates of additional costs to be incurred. If revised forecasted or actual product sales are less than and/or revised forecasted or actual costs are greater than the original forecasted amounts utilized in the initial recoverability analysis, the net realizable value may be lower than originally estimated in any given quarter, which could result in an impairment charge.

Intellectual Property Licenses. Intellectual property license costs represent license fees paid to intellectual property rights holders for use of their trademarks, copyrights, software, technology or other intellectual property or proprietary rights in the development of our products. Depending upon the agreement with the rights holder, we may obtain the rights to use acquired intellectual property in multiple products over multiple years, or alternatively, for a single product.

We evaluate the future recoverability of capitalized intellectual property licenses on a quarterly basis. The recoverability of capitalized intellectual property license costs is evaluated based on the expected performance of the specific products in which the licensed trademark or copyright is to be used. As many of our intellectual property licenses extend for multiple products over multiple years, we also assess the recoverability of capitalized intellectual property license costs based on certain qualitative factors such as the success of other products and/or entertainment vehicles utilizing the intellectual property, whether there are any future planned theatrical releases or television series based on the intellectual property and the rights holder s continued promotion and exploitation of the intellectual property. Prior to the related product s release, we expense, as part of cost of sales intellectual property licenses, capitalized intellectual property costs when we believe such amounts are not recoverable. Capitalized intellectual property costs for those products that are cancelled or abandoned are charged to product development expense in the period of cancellation. Criteria used to evaluate expected product performance include: historical performance of comparable products using comparable technology; orders for the product prior to its release; and estimated performance of a sequel product based on the performance of the product on which the sequel is based.

Commencing upon the related product s release, capitalized intellectual property license costs are amortized to cost of sales intellectual property licenses based on the ratio of current revenues for the specific product to total projected revenues for all products in which the licensed property will be utilized. As intellectual property license contracts may extend for multiple years, the amortization of capitalized intellectual property license costs relating to such contracts may extend beyond one year. For intellectual property included in products that have been released and unreleased products, we evaluate the future recoverability of capitalized amounts on a quarterly basis. The primary evaluation criterion is actual title performance.

Significant management judgments and estimates are utilized in the assessment of the recoverability of capitalized costs. In evaluating the recoverability of capitalized costs, the assessment of expected product performance utilizes forecasted sales amounts and estimates of additional costs to be incurred. If revised forecasted or actual product sales are less than, and/or revised forecasted or actual costs are greater than, the original forecasted amounts utilized in the initial recoverability analysis, the net realizable value may be lower than originally estimated in any given quarter, which could result in an impairment charge. Additionally, as noted above, as many of our intellectual property licenses extend for multiple products over multiple years, we also assess the recoverability of capitalized intellectual property license costs based on certain qualitative factors such as the success of other products and/or entertainment vehicles utilizing the intellectual property, whether there are any future planned theatrical releases or television series based on the intellectual property and the rights holder s continued promotion and exploitation of the intellectual property. Material differences may result in the amount and timing of charges for any period if management makes different judgments or utilizes different estimates in evaluating these qualitative factors.

The following table sets forth certain consolidated statements of operations data for the periods indicated as a percentage of total net revenues and also breaks down net revenues by territory, business segment and platform, as well as operating income by business segment (amounts in thousands):

	Three months ended December 31,				Nine months ended December 31,			
	2004		2003		2004		2003	
Net revenues	$ 680,094	100 %	$ 508,511	100 %	$ 1,201,996	100 %	$ 784,759	100 %
Costs and expenses:								
Cost of sales product costs	316,494	47	235,301	46	528,759	44	384,302	49
Cost of sales software royalties and amortization	58,200	9	23,680	5	116,846	10	50,575	7
Cost of sales intellectual property licenses	22,598	3	9,464	2	57,797	5	27,008	3
Product development	25,068	4	50,354	10	66,054	5	79,828	10
Sales and marketing	105,248	15	58,503	11	200,216	16	102,025	13
General and administrative	15,407	2	14,248	3	44,854	4	35,847	5
Total costs and expenses	543,015	80	391,550	77	1,014,526	84	679,585	87
Operating income	137,079	20	116,961	23	187,470	16	105,174	13
Investment income, net	3,197		1,464		7,954		4,125	1
Income before income tax provision	140,276	20	118,425	23	195,424	16	109,299	14
Income tax provision	43,014	6	41,444	8	60,662	5	38,248	5
Net income	$ 97,262	14 %	$ 76,981	15 %	$ 134,762	11 %	$ 71,051	9 %
Net Revenues by Territory:								
United States	$ 344,342	51 %	$ 252,114	50 %	$ 627,238	52 %	$ 381,303	49 %
Europe	324,360	48	246,919	48	543,480	45	385,952	49
Other	11,392	1	9,478	2	31,278	3	17,504	2
Total net revenues	$ 680,094	100 %	$ 508,511	100 %	$ 1,201,996	100 %	$ 784,759	100 %
Net Revenues by Segment/Platform Mix Publishing:								
Console	$ 382,400	56 %	$ 304,996	60 %	$ 647,069	54 %	$ 439,499	56 %
Hand-held	63,243	9	13,367	3	105,342	9	22,150	3
PC	68,410	11	64,558	12	189,689	15	107,473	14
Total publishing net revenues	514,053	76	382,921	75	942,100	78	569,122	73
Distribution:								
Console	134,503	20	102,979	20	203,626	17	171,509	22
Hand-held	7,923	1	6,917	2	15,134	1	14,559	2
PC	23,615	3	15,694	3	41,136	4	29,569	3

Total distribution net revenues	166,041	24	125,590	25	259,896	22	215,637	27
Total net revenues	$ 680,094	100%	$ 508,511	100%	$ 1,201,996	100%	$ 784,759	100%
Operating Income by Segment:								
Publishing	$ 120,608	18%	$ 104,964	21%	$ 168,111	14%	$ 93,240	12%
Distribution	16,471	2	11,997	2	19,359	2	11,934	1
Total operating income	$ 137,079	20%	$ 116,961	23%	$ 187,470	16%	$ 105,174	13%

Results of Operations Three and Nine Months Ended December 31, 2004 and 2003

Net income for the three months ended December 31, 2004 was $97.3 million or $0.63 per diluted share, as compared to $77.0 million or $0.53 per diluted share for the three months ended December 31, 2003.

Net income for the nine months ended December 31, 2004 was $134.8 million or $0.87 per diluted share, as compared to $71.1 million or $0.49 per diluted share for the nine months ended December 31, 2003.

Net Revenues

We primarily derive revenue from sales of packaged interactive software games designed for play on video game consoles (such as the PS2, Xbox and GameCube), PCs and hand-held game devices (such as the GBA and NDS). We also derive revenue from our distribution business in Europe that provides logistical and sales services to third-party publishers of interactive entertainment software, our own publishing operations and third-party manufacturers of interactive entertainment hardware.

The following table details our consolidated net revenues by business segment and our publishing net revenues by territory for the three months ended December 31, 2004 and 2003 (in thousands):

	Three Months ended December 31,					Percent
	2004		2003		Increase/ (Decrease)	Change
Publishing Net Revenues						
North America	$ 344,342		$ 252,114		$ 92,228	37%
Europe	158,319		121,329		36,990	30%
Other	11,392		9,478		1,914	20%
Total International	169,711		130,807		38,904	30%
Total Publishing Net Revenues	514,053		382,921		131,132	34%
Distribution Net Revenues	166,041		125,590		40,451	32%
Consolidated Net Revenues	$ 680,094		$ 508,511		$ 171,583	34%

Consolidated net revenues increased 34% from $508.5 million for the three months ended December 31, 2003 to $680.1 million for the three months ended December 31, 2004. This increase was driven by our publishing business both in North America and internationally. The increase in consolidated net revenues was driven by the following:

Strong performances from new releases in the third quarter of fiscal 2005, consistent with the comparable period of fiscal 2004. In the third quarter of fiscal 2005, we released *Call of Duty: Finest Hour, THUG 2, Lemony Snicket s A Series of Unfortunate Events, Cabela s Big Game Hunter 2005,* and *Spider-Man 2* for NDS. This compares to strong releases in the third quarter of fiscal 2004: *Tony Hawk s Underground (THUG), True Crime: Streets of L.A.*, *Cabela s Dangerous Hunts, Call of Duty*, *Empires: Dawn of the Modern World*, and, in select European markets, *Rouge Squadron III: Rebel Strike*.

Continued strong performance of our catalog titles, which are titles released prior to the current quarter, particularly *Spider-Man 2, Shrek 2, Shark Tale*, *X-Men Legends,* and *Rome: Total War.* Catalog sales for the three months ended December 31, 2004 increased $127.1 million over the same period last year due to marketing strategies aimed at extending the product life cycle of successful catalog titles into the holiday season.

International Publishing and Distribution net revenues benefited from the strong year-over-year strengthening of the Euro (EUR) and Great Britain Pound (GBP) in relation to the U.S. Dollar. Foreign exchange rates increased reported net revenue by approximately $27.9 million. Excluding the impact of changing foreign currency rates, our International Publishing and Distribution net revenue increased 20%

year-over-year.

The following table details our consolidated net revenues by business segment and our publishing net revenues by territory for the nine months ended December 31, 2004 and 2003 (in thousands):

	Nine Months ended December 31, 2004		2003		Increase/ (Decrease)	Percent Change
Publishing Net Revenues						
North America	$	627,238	$	381,303	$ 245,935	64%
Europe		283,584		170,315	113,269	67%
Other		31,278		17,504	13,774	79%
Total International		314,862		187,819	127,043	68%
Total Publishing Net Revenues		942,100		569,122	372,978	66%
Distribution Net Revenues		259,896		215,637	44,259	21%
Consolidated Net Revenues	$	1,201,996	$	784,759	$ 417,237	53%

Consolidated net revenues increased 53% from $784.8 million for the nine months ended December 31, 2003 to $1,202.0 million for the nine months ended December 31, 2004. This increase was driven mainly by our publishing business. The increase in consolidated net revenue was driven by the following:

For the nine months ended December 31, 2004, we released *Spider-Man 2, Shrek 2, Doom 3, Call of Duty: United Offensive*, *Rome: Total War, X-Men Legends, Shark Tale*, *Cabela s Deer Hunt 2005 Season, Call of Duty: Finest Hour, THUG 2, Lemony Snicket s A Series of Unfortunate Events, Cabela s Big Game Hunter 2005,* and *Spider-Man 2* for NDS. Sales of these titles significantly outperformed the eleven major titles released in the first nine months of fiscal 2004.

International Publishing and Distribution net revenues benefited from the strong year-over-year strengthening of the EUR and GBP in relation to the U.S. Dollar. Foreign exchange rates increased reported net revenue by approximately $51.2 million for the nine-months ended December 31, 2004. Excluding the impact of changing foreign currency rates, our international net revenue increased 30% year-over-year.

North America Publishing Net Revenue (in thousands)

	December 31, 2004	% of Consolidated Net Revenue	December 31, 2003	% of Consolidated Net Revenue	Increase/ (Decrease)	Percent Change
Three Months Ended	$ 344,342	51%	$ 252,114	50%	$ 92,228	37%
Nine Months Ended	$ 627,238	52%	$ 381,303	49%	$ 245,935	64%

Domestic publishing net revenues increased 37% from $252.1 million for the three months ended December 31, 2003, to $344.3 million for the three months ended December 31, 2004. The increase reflects our fiscal 2005 third quarter releases of *Call of Duty: Finest Hour, THUG 2, Lemony Snicket s A Series of Unfortunate Events, Cabela s Big Game Hunter 2005,* and *Spider-Man 2* for the NDS which performed comparably to our strong slate of fiscal 2004 third quarter releases. In addition, the strong performance of catalog sales from a number of our franchises, including *Spider-Man 2*, *Shrek 2, Shark Tale*, *X-Men Legends,* and *Rome: Total War* contributed to the quarter over quarter increase.

For the nine months ended December 31, 2004, domestic publishing net revenues increased 64% from $381.3 million at December 31, 2003 to $627.2 million. The increase reflects the strong performance of our fiscal 2005 releases of *Spider-Man 2, Shrek 2, Doom 3, Call of Duty: United Offensive*, *Rome: Total War, X-Men Legends, Shark Tale*, *Cabela s Deer Hunt 2005 Season, Call of Duty: Finest Hour, THUG 2, Lemony Snicket s A Series of Unfortunate Events, Cabela s Big Game Hunter 2005.* We also launched our first release for the NDS, *Spider-Man 2.*

International Publishing Net Revenue (in thousands)

		December 31, 2004	% of Consolidated Net Revenue		December 31, 2003	% of Consolidated Net Revenue		Increase/ (Decrease)	Percent Change
Three Months Ended	$	169,711	25%	$	130,807	26%	$	38,904	30%
Nine Months Ended		314,862	26%		187,819	24%	$	127,043	68%

International publishing net revenues increased by 30% from $130.8 million for the three months ended December 31, 2003, to $169.7 million for the three months ended December 31, 2004. International publishing saw strong results from our fiscal 2005 third quarter releases of *Call of Duty: Finest Hour* and *THUG 2*. In addition *Rome: Total War, X-Men Legends, and Shark Tale,* were released in all international territories after only limited international territorial releases in the second quarter of fiscal 2005. Net revenues also improved due to the expansion of our European operations into Spain and Italy. There was a positive strengthening of the EUR, Australian Dollar (AUD), and the GBP in relation to the U.S. dollar of approximately $13.6 million. Excluding the impact of changing foreign currency rates, our international publishing net revenue increased 19% year-over-year.

International publishing net revenues increased by 68% from $187.8 million for the nine months ended December 31, 2003, to $314.9 million for the nine months ended December 31, 2004. International publishing saw strong results from our fiscal 2005 third quarter releases as mentioned above and the releases of *Shrek 2, Doom* 3 *and Spider-Man 2* in the first half of fiscal 2005. In addition, net revenues were improved due to the expansion of our European operations into Spain and Italy. There was a positive strengthening of the EUR, AUD, and the GBP in relation to the U.S. Dollar of approximately $27.5 million for the nine months ended December 31, 2004 compared to the nine months ended December 31, 2003. Excluding the impact of changing foreign currency rates, our international publishing net revenue increased 53% year-over-year.

Publishing Net Revenue by Platform

Publishing net revenues increased 34% from $382.9 million for the three months ended December 31, 2003 to $514.1 million for the three months ended December 31, 2004. The following table details our publishing net revenues by platform and as a percentage of total publishing net revenues for the three months ended December 31, 2004 and 2003 (in thousands):

		Quarter Ended December 31, 2004	% of Publishing Net Revs.		Quarter Ended December 31, 2003	% of Publishing Net Revs.		Increase/ (Decrease)	Percent Change
Publishing Net Revenues									
PC	$	68,410	13%	$	64,558	17%	$	3,852	6%
Console									
PlayStation 2		227,759	44%		183,387	48%		44,372	24%
Microsoft Xbox		105,716	21%		75,023	20%		30,693	41%
		48,002	10%		39,550	10%		8,452	21%

Nintendo GameCube								
Other		923	%		7,036	2%	(6,113)	(87)%
Total Console		382,400	75%		304,996	80%	77,404	25%
Hand-held		63,243	12%		13,367	3%	49,876	373%
Total Publishing Net Revenues	$	514,053	100%	$	382,921	100%	$ 131,132	34%

Publishing net revenues increased 66% from $569.1 million for the nine months ended December 31, 2003 to $942.1 million for the nine months ended December 31, 2004. The following table details our publishing net revenues by platform and as a percentage of total publishing net revenues for the nine months ended December 31, 2004 and 2003 (in thousands):

	Nine Months Ended December 31, 2004	**% of Publishing Net Revs.**	**Nine Months Ended December 31, 2003**	**% of Publishing Net Revs.**	**Increase/ (Decrease)**	**Percent Change**
Publishing Net Revenues						
PC	$ 189,689	20%	$ 107,473	19%	$ 82,216	76%
Console						
PlayStation 2	384,225	41%	249,041	44%	135,184	54%
Microsoft Xbox	168,315	18%	123,110	22%	45,205	37%
Nintendo GameCube	92,471	10%	48,632	8%	43,839	90%
Other	2,058	%	18,716	3%	(16,658)	(89)%
Total Console	647,069	69%	439,499	77%	207,570	47%
Hand-held	105,342	11%	22,150	4%	83,192	376%
Total Publishing Net Revenues	$ 942,100	100%	$ 569,122	100%	$ 372,978	66%

Personal Computer Net Revenue (in thousands)

	December 31, 2004	**% of Publishing Net Revenue**	**December 31, 2003**	**% of Publishing Net Revenue**	**Increase/ (Decrease)**	**Percent Change**
.						
Three Month Ended	$ 68,410	13%	$ 64,558	17%	$ 3,852	6%
Nine Months Ended	189,689	20%	107,473	19%	82,216	76%

Net revenue from sales of titles for the PC increased 6% from $64.6 million for the three months ended December 31, 2003 to $68.4 million for the three months ended December 31, 2004. The increase was driven by continued strong sales of our catalog titles, specifically *Rome: Total War, Call of Duty, Call of Duty: United Offensive,* and *Doom 3* combined with the release of *Vampires - The Masquerade: Bloodlines* in the third quarter of fiscal 2005. This compares to the releases of two premium PC titles in the third quarter of fiscal 2004, *Call of Duty* and *Empires: Dawn of the Modern World,* both of which performed very well in both the domestic and international markets.

Net revenue from sales of titles for the PC increased 76% from $107.5 million for the nine months ended December 31, 2003 to $189.7 million for the nine months ended December 31, 2004. The increase was driven mainly by the releases of numerous big proposition titles including the releases of *Spider-Man 2* and *Shrek 2* in the first quarter of fiscal 2005 and *Doom 3, Rome: Total War,* and *Call of Duty: United Offensive* in the second quarter of fiscal 2005 and *Vampires The Masquerade: Bloodlines* in the third quarter of fiscal 2005. According to NPD, we were the only publisher to have three top-ten PC titles for the calendar year *Doom 3, Call of Duty, and Rome: Total War.* This compares to the releases of four new PC titles in the nine months ended December 31, 2003, *Call of Duty, Empires: Dawn of the Modern World, X2: Wolverine s*

Revenge, and *Medieval Total War: Viking Invasion*.

We expect fiscal 2005 PC publishing net revenues to continue to increase over fiscal 2004 due to continued catalog sales of *Call of Duty, Call of Duty: United Offensive,* and *Rome: Total War*.

PlayStation 2 Net Revenue (in thousands)

		December 31, 2004	% of Publishing Net Revenue		December 31 2003	% of Publishing Net Revenue		Increase/ (Decrease)	Percent Change
Three Months Ended	$	227,759	44%	$	183,387	48%	$	44,372	24%
Nine Months Ended		384,225	41%		249,041	44%		135,184	54%

Net revenue from sales of titles for the PS2 increased 24% from $183.4 million for the three months ended December 31, 2003 to $227.8 million for the three months ended December 31, 2004. This was driven by strong sales of the third quarter fiscal 2005 title releases of *THUG 2, Call of Duty: Finest Hour, Lemony Snicket s A Series of Unfortunate Events,* and *Cabela s Big Game Hunter 2005* and strong catalog sales of *X-Men Legends, Spider-Man 2,* and *Shrek 2*. This compares to a majority of third quarter fiscal 2004 PS2 revenues being driven by two titles, *THUG* and *True Crime: Streets of L.A.*

Net revenue from sales of titles for the PS2 increased 54% from $249.0 million for the nine months ended December 31, 2003 to $384.2 million for the nine months ended December 31, 2004. This was driven by the third quarter releases discussed above and the strong sales of other fiscal 2005 releases including *Spider-Man 2*, *Shrek 2, Shark Tale, X-Men Legends, Cabela s Deer Hunt 2005,*and *Rapala s Pro Fishing.*

We expect the overall installed base of the PS2 to continue to increase, as product availability allows, for the remainder of the fiscal year due to price cuts in calendar 2004 and a redesigned PS2 console. As the installed base increases we expect our overall net revenues from PS2 sales to continue to increase over prior periods.

Microsoft Xbox Net Revenue (in thousands)

		December 31, 2004	% of Publishing Net Revenue		December 31 2003	% of Publishing Net Revenue		Increase/ (Decrease)	Percent Change
Three Months Ended	$	105,716	21%	$	75,023	20%	$	30,693	41%
Nine Months Ended		168,315	18%		123,110	22%		45,205	37%

Net revenue from sales of titles for the Xbox increased 41% from $75.0 million for the three months ended December 31, 2003 to $105.7 million for the three months ended December 31, 2004. The increase is due to the strong slate of new releases in the third quarter of fiscal 2005 including *THUG 2, Lemony Snicket s A Series of Unfortunate Events, Call of Duty: Finest Hour, Cabela s Big Game Hunter 2005* and *Greg Hasting s Tournament Paintball* combined with strong catalog sales titles such as *X-Men Legends.* In the third quarter of fiscal 2004, Xbox net revenues were driven by two releases, *THUG* and *True Crime: Streets of L.A.*

Net revenue from sales of titles for the Xbox increased 37% from $123.1 million for the nine months ended December 31, 2003 to $168.3 million for the nine months ended December 31, 2004. The increase is due to the strength of the third quarter releases mentioned above combined with strong catalog performances of *X-Men Legends, Spider-Man 2, Shrek 2,* and *Shark Tale*. This compares to the titles released in fiscal 2004, *X2: Wolverine s Revenge, Return to Castle Wolfenstein, Wakeboarding Unleashed*, *Soldier of Fortune II: Double Helix*, *THUG,* and *True Crime: Streets of L.A.* The increasing installed base of the Xbox, which sold 4 million units during calendar 2004, continues to lead to increases in our overall net revenues.

The Xbox gained market share in calendar 2004. As the installed base increases we expect our overall net revenues from Xbox sales to continue to increase over prior periods.

Nintendo GameCube Net Revenue (in thousands)

	December 31, 2004	% of Publishing Net Revenue	December 31, 2003	% of Publishing Net Revenue	Increase/ (Decrease)	Percent Change
Three Months Ended	$ 48,002	10%	$ 39,550	10%	$ 8,452	21%
Nine Months Ended	92,471	10%	48,632	8%	43,839	90%

Net revenue from sales of titles for the Nintendo GameCube increased 21% from $39.6 million for the three months ended December 31, 2003 to $48.0 million for the three months ended December 31, 2004. The increase is mainly due to strong third quarter fiscal 2005 new releases of *THUG 2, Call of Duty: Finest Hour,* and *Lemony Snicket s A Series of Unfortunate Events*. In addition, strong catalog sales of *X-Men Legends, Spider-Man 2, Shrek 2,* and *Shark Tale* continued into the third quarter of fiscal 2005. This compares to a majority of third quarter fiscal 2004 net revenues being provided by three titles, *THUG, True Crime: Streets of L.A.,* and, in select European markets *Rogue Squadron III: Rebel Strike.*

Net revenue from sales of titles for the Nintendo GameCube increased 90% from $48.6 million for the nine months ended December 31, 2003 to $92.5 million for the nine months ended December 31, 2004. The overall increase is due mainly to the strong performance of fiscal 2005 first half releases of *Spider-Man 2*, *Shrek 2, Shark Tale* and *X-Men Legends* and our third quarter releases of *Lemony Snicket s A Series of Unfortunate Events* as these titles were targeted toward the demographic of the GameCube audience. In addition, the third quarter fiscal 2005 release of *Call of Duty: Finest Hour* had strong sales on the GameCube.

Due to increased marketing support to extend the life cycle of successful titles, we expect continued strong catalog sales on the GameCube to increase over comparable prior year periods.

Hand-Held (in thousands)

	December 31, 2004	% of Publishing Net Revenue	December 31, 2003	% of Publishing Net Revenue	Increase/ (Decrease)	Percent Change
Three Months Ended	$ 63,243	12%	$ 13,367	3%	$ 49,876	373%
Nine Months Ended	105,342	11%	22,150	4%	83,192	376%

Net revenue from sales of titles for hand-held platforms for the three months ended December 31, 2004 increased 373% from the prior fiscal year, from $13.4 million to $63.2 million. The increase is due to a customized marketing plan against platform and demographic leading to a strong slate of new releases during the third quarter of fiscal 2005 including *THUG 2* and a GBA exclusive release, *Shrek 2: Beg for Mercy!*. GBA catalog titles such as *Spider-Man 2, Shrek 2,* and *Shark Tale* continued to perform strongly in the third quarter. Further adding to the increase in hand-held revenues, the NDS platform was launched in November 2004. Coinciding with the platform launch we released our first NDS title, *Spider-Man 2*. This all compares to the release of only one hand-held title, *THUG,* in the third quarter of fiscal 2004.

Net revenue from sales of titles for hand-held platforms for the nine months ended December 31, 2004 increased 376% from the prior fiscal year, from $22.2 million to $105.3 million. The increase is due to a customized marketing plan against platform and demographic leading to a strong slate of new releases during leading to the strong performance of five GBA releases, *THUG 2, Shrek 2: Beg for Mercy!, Shark Tale*, *Spider-Man 2* and *Shrek 2* which were all targeted toward the demographic of the GBA audience. Also, as mentioned above, we released our first NDS title, *Spider-Man 2*. By contrast, there were three releases in the nine months ended December 31, 2003, *THUG, Disney s Extreme Skate Adventure* and *X2: Wolverine s Revenge.*

We expect the overall hand-held market to grow significantly with the recent release of the NDS, the future release of the PSP, and the price cut of the GBA earlier in fiscal 2005. However, with the fiscal third quarter release of the NDS and upcoming release of PSP we expect that market share for the GBA will eventually begin to decrease while the overall hand-held market will continue to expand with a growing installed base and broader demographic on the newer platforms. We expect to continue our focus on developing hand-held games for mass-market consumers including for the next generation hand-held platforms, PSP and NDS. However, we expect an increase in the level of competition.

Overall

The platform mix of our future publishing net revenues will likely be impacted by a number of factors, including the ability of hardware manufacturers to continue to increase their installed hardware base and the introduction of new hardware platforms, as well as the timing of key product releases from our product release schedule. We expect that net revenues from console titles will continue to represent the largest component of our publishing net revenues with PS2 having the largest percentage of that business due to its larger installed hardware base. We expect net revenues from hand-held titles to remain the smallest component of our publishing net revenues. However, with the recent release of the NDS and the upcoming release of the PSP, we may continue to see an increase in our hand-held business in comparison to prior periods. Our net revenues from PC titles will be primarily driven by our product release schedule as that market has not been growing at rates comparable to console and hand-held.

A significant portion of our revenues and profits are derived from a relatively small number of popular titles and brands each year as revenues and profits are significantly affected by our ability to release highly successful titles. For example, for the three months ended December 31, 2004, 33% of our consolidated net revenues and 43% of worldwide publishing net revenues were derived from net revenues from our *THUG 2* and *Call of Duty: Finest Hour* titles. For the nine months ended December 31, 2004, 34% of our consolidated net revenues and 43% of worldwide publishing net revenues were derived from net revenues from our *Spider-Man 2, THUG 2*, *and Call of Duty: Finest Hour* titles. Though many of these titles have substantial production or acquisition costs and marketing budgets, once a title recoups these costs, incremental net revenues directly and positively impact operating profits resulting in a disproportionate amount of operating income being derived from these select titles. We expect that a limited number of titles and brands will continue to produce a disproportionately large amount of our net revenues and profits.

Two factors that could affect future publishing and distribution net revenue performance are console hardware pricing and software pricing. As console hardware moves through its life cycle, hardware manufacturers typically enact price reductions. Reductions in the price of console hardware typically result in an increase in the installed base of hardware owned by consumers. Price cuts on Xbox, PS2, and GBA hardware were announced in March, May, and September 2004, respectively. Historically, we have also seen that lower console hardware prices put downward pressure on software pricing. While we expect console software launch pricing at retail for most genres to hold at $49.99 through fiscal 2005, we believe we could see software price declines thereafter.

Distribution Net Revenue (in thousands)

	December 31, 2004	**% of Consolidated Net Revenue**	**December 31, 2003**	**% of Consolidated Net Revenue**	**Increase/ (Decrease)**	**Percent Change**
Three Months Ended	$ 166,041	24%	$ 125,590	25%	$ 40,451	32%
Nine Months Ended	259,896	22%	215,637	27%	44,259	21%

Hand-Held (in thousands)

Distribution net revenues for the three months ended December 31, 2004 increased 32% from the prior fiscal year, from $125.6 million to $166.0 million. The increase was primarily due to a strong industry wide software market, an increase in sales to mass merchants and a change in the product mix. For the three months ended December 31, 2004 hardware sales represented 12% of distribution net revenues compared to 33% in the prior year third quarter. In addition, there was a positive impact of the year-over-year strengthening of the EUR and the GBP in relation to the U.S. dollar of $14.3 million. Excluding the impact of the changing foreign currency rates, our distribution net revenue increased 21% year-over-year.

Distribution net revenues for the nine months ended December 31, 2004 increased 21% from the prior fiscal year, from $215.6 million to $259.9 million. Consistent with above, the increase was primarily due to the continued growth in the industry wide software market, an increase in sales to mass merchants, as well as a change in the product mix. For the nine months ended December 31, 2004 hardware sales represented 12% of distribution net revenues compared to 29% in the prior year third quarter. In addition, there was a positive impact of the year-over-year strengthening of the EUR and the GBP in relation to the U.S. Dollar for the nine months ended December 31, 2004 of $23.7 million. Excluding the impact of the changing foreign currency rates, our distribution net revenue increased 10% year-over-year.

The mix of future distribution net revenues will be driven by a number of factors including the occurrence of further hardware price reductions instituted by hardware manufacturers, the introduction of new hardware platforms, our ability to establish and maintain distribution agreements with hardware manufacturers and third-party software publishers and the success of third-party published titles. We are expecting our total fiscal 2005 distribution revenues to be consistent with the year to date performance.

Costs and Expenses

Cost of Sales Product Costs (in thousands)

	December 31, 2004	% of Consolidated Net Revenue	December 31, 2003	% of Consolidated Net Revenue	Increase/ (Decrease)	Percent Change
Three Months Ended	$ 316,494	47%	$ 235,301	46%	$ 81,193	35%
Nine Months Ended	528,759	44%	384,302	49%	144,457	38%

Cost of sales product costs represented 47% and 46% of consolidated net revenues for the three months ended December 31, 2004 and 2003, respectively. In absolute dollars, cost of sales product costs increased 35% which is proportionate to the increase in sales volume in the third quarter of fiscal 2005 as compared to the third quarter of fiscal 2004.

Cost of sales product costs represented 44% and 49% of consolidated net revenues for the nine months ended December 31, 2004 and 2003, respectively. In absolute dollars, cost of sales product costs increased 38% due to significantly higher sales in the first nine months of fiscal 2005 as compared to the first nine months of fiscal 2004. The primary factors affecting the reduction in the cost of sales product costs as a percentage of consolidated net revenues are:

Increased ability to maintain premium pricing on big proposition titles for the nine months ended December 31, 2004.

An increase in publishing net revenues from sales of PC titles by 76% year to date over the same period of fiscal 2004. PC publishing revenues as a percent of publishing net revenues for the nine months also grew from 19% to 20%. PC titles typically have less product costs associated with them.

A lower percentage of revenues generated from our distribution business for nine months ended December 31, 2004.

We expect cost of sales product costs as a percentage of net revenues to continue to be lower than the comparable period in the prior fiscal year throughout fiscal 2005. This is primarily due to a lower percentage of revenue generated from our distribution business in fiscal 2005, which is a lower margin business. We may also continue to experience a benefit from changes in product mix in fiscal 2005 due to the focus on big proposition titles, for which we could benefit from higher retail pricing and manufacturing volume discounts.

Cost of Sales Software Royalties and Amortization (in thousands)

	December 31, 2004	% of Publishing Net Revenue	December 31, 2003	% of Publishing Net Revenue	Increase/ (Decrease)	Percent Change
Three Months Ended	$ 58,200	11%	$ 23,680	6%	$ 34,520	146%
Nine Months Ended	116,846	12%	50,575	9%	66,271	131%

Cost of sales software royalties and amortization as a percentage of publishing net revenues increased from 6% for the three months ended December 31, 2003 to 11% for the three months ended December 31, 2004. In absolute dollars, cost of sales software royalties and amortization for the three months ended December 31, 2004 increased from the prior fiscal year, from $23.7 million to $58.2 million or 146%. The increases in both the percentage of publishing net revenues and in absolute dollars is due to the mix of internally and externally developed titles and an increase in number of titles released. The releases of *Call of Duty: Finest Hour, Rome: Total War, Vampire The Masquerade: Bloodlines,* and *Lemony Snicket s A Series of Unfortunate Events* in the third quarter of fiscal 2005 were externally developed and thus have higher royalties associated with them. Further contributing to the increase is an increase in the overall costs to develop games. This compares to third quarter of fiscal 2004 in which a significant portion of revenues were derived from internally developed titles with lower associated game development costs.

Cost of sales software royalties and amortization as a percentage of publishing net revenues increased from 9% for the nine months ended December 31, 2003 to 12% for the nine month ended December 31, 2004. In absolute dollars, cost of sales software royalties and amortization for the nine months ended December 31, 2004 increased $66.3 million from the prior fiscal year, from $50.6 million for the nine months ended December 31, 2003 to $116.8 million. This increase is due to the release of titles such as *Call of Duty: Finest Hour*, *Doom 3* and *Lemony Snicket s A Series of Unfortunate Events,* which were externally developed and have higher royalties rates associated with them. Further contributing to the increase is an increase in the overall costs to develop games. This compares to fiscal 2004 in which a significant portion of revenues were derived from internally developed titles with lower associated game development costs.

Cost of Sales Intellectual Property Licenses (in thousands)

	December 31, 2004	% of Publishing Net Revenue	December 31, 2003	% of Publishing Net Revenue	Increase/ (Decrease)	Percent Change
Three Months Ended	$ 22,598	4%	$ 9,464	2%	$ 13,134	139%
Nine Months Ended	57,797	6%	27,008	5%	30,789	114%

Cost of sales intellectual property licenses for the three months ended December 31, 2004 increased in absolute dollars by 139% from $9.5 million for the three months ended December 31, 2003 to $22.6 million for the three months ended December 31, 2004 while the percentage of publishing net revenues also increased from 2% to 4%. The increases are due to the release of more titles with associated licensed intellectual property as well as continued strong catalog sales of titles with associated licensed intellectual property. Fiscal 2005 third quarter net revenues from titles with associated intellectual property licenses represented 52% of publishing net revenue compared to 44% in the third quarter of fiscal 2004.

Cost of sales intellectual property licenses for the nine months ended December 31, 2004 increased in absolute dollars by 114% from $27.0 million for the nine months ended December 31, 2003 to $57.8 million for the nine months ended December 31, 2004 while the percentage of publishing net revenues increased from 5% to 6%. Consistent with the third quarter, the increases are due to the release of more titles with associated licensed intellectual property compared to the titles released in fiscal 2004 for which a significant portion of revenues was derived from titles that were internally developed with no associated intellectual property.

We expect cost of sales intellectual property licenses to increase in fiscal 2005 as compared to fiscal 2004, as we have had more titles released and higher catalog sales of titles with associated licensed intellectual property.

Product Development (in thousands)

	December 31, 2004	% of Publishing Net Revenue	December 31, 2003	% of Publishing Net Revenue	Increase/ (Decrease)	Percent Change
Three Months Ended	$ 25,068	5%	$ 50,354	13%	$ (25,286)	(50)%
Nine Months Ended	66,054	7%	79,828	14%	(13,774)	(17)%

Product development expenses for the three months ended December 31, 2004 decreased as a percentage of publishing net revenues as compared to the three months ended December 31, 2003, from 13% to 5%. In absolute dollars, product development expenses for the three months ended December 31, 2004 decreased approximately $25.3 million compared to the three months ended December 31, 2003, from $50.4 million to $25.1 million. The decreases primarily relate to a pre-tax charge of approximately $21 million taken in the third quarter of fiscal 2004 related to the cancellation of products which were believed to be unlikely to produce an acceptable level of return on our investment. Excluding the impact of the pre-tax charge, product development expenses for the three months ended December 31, 2004 decreased by $4.3 million.

Product development expenses for the nine months ended December 31, 2004 decreased as a percentage of publishing net revenues as compared to the nine months ended December 31, 2003, from 14% to 7%. In absolute dollars, product development expenses for the nine months ended December 31, 2004 decreased approximately $13.8 million compared to the nine months ended December 31, 2003, from $79.8 million to $66.1 million. The decreases relate primarily to the pre-tax charge discussed above offset by higher game development costs as development time and team sizes as well as quality assurance time increased due to enhanced production values and to support more complex and robust gaming experiences.

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Sales and Marketing (in thousands)

	December 31, 2004	% of Consolidated Net Revenue	December 31, 2003	% of Consolidated Net Revenue	Increase/ (Decrease)	Percent Change
Three Months Ended	$ 105,248	15%	$ 58,503	11%	$ 46,745	80%
Nine Months Ended	200,216	16%	102,025	13%	98,191	96%

Sales and marketing expenses of $105.2 million and $58.5 million represented 15% and 11% of consolidated net revenues for the three months ended December 31, 2004 and 2003, respectively. The increases both in absolute dollars and as a percentage of net revenues was primarily generated by our publishing business as a result of significant marketing programs, including television and in-theatre ad campaigns and in-store promotions, run in support of our three key fiscal 2005 third quarter big proposition title releases, *THUG 2, Call of Duty: Finest Hour,* and *Lemony Snicket s A Series of Unfortunate Events.* In addition, there were significant marketing programs implemented to sustain catalog sales of such titles as *Shark Tale, X-Men Legends, Spider-Man 2* and *Shrek 2* titles through the holiday season.

Sales and marketing expenses increased 96% from $102.0 million and 13% of consolidated net revenue for the nine months ended December 31, 2003 to $200.2 million and 16% of consolidated net revenue for the nine months ended December 31, 2004. The increases both in absolute dollars and as a percentage of net revenues was primarily generated by our publishing business as a result of significant marketing programs, including television and in-theatre ad campaigns and in-store promotions, run in support of our key fiscal 2005 big proposition title releases, *Spider-Man 2*, *Shrek 2, Doom 3, Shark Tale, X-Men Legends, THUG 2, Call of Duty: Finest Hour,* and *Lemony Snicket s A Series of Unfortunate Events.* We currently believe that this increased spending will lengthen the product sales life cycle and add to the long-term prospects of the respective product lines.

We expect to continue to provide significant marketing support for our future big proposition titles in launch and subsequent quarters. Accordingly, we expect fiscal 2005 sales and marketing costs to continue to exceed fiscal 2004 spending levels.

General and Administrative (in thousands)

	December 31, 2004	% of Consolidated Net Revenue	December 31, 2003	% of Consolidated Net Revenue	Increase/ (Decrease)	Percent Change
Three Months Ended	$ 15,407	2%	$ 14,248	3%	$ 1,159	8%
Nine Months Ended	44,854	4%	35,847	5%	9,007	25%

General and administrative expenses for the three months ended December 31, 2004 increased $1.2 million over the same period last year, from $14.2 million to $15.4 million. As a percentage of consolidated net revenues, general and administrative expenses decreased from 3% to 2% for the three months ended December 31, 2003 and 2004, respectively. The increase in absolute dollars was primarily due to an increase in professional services fees associated with Sarbanes-Oxley related compliance as well as increase in headcount to support business growth. The decrease as a percentage of consolidated net revenue is due mainly to the significant increase in sales volume.

For the nine months ended December 31, 2004, general and administrative expenses increased $9.0 million or 25% over the same period last year, from $35.8 million to $44.9 million. As a percentage of consolidated net revenues, general and administrative expenses declined from 5% to 4%. Consistent with above, the increase in absolute dollars was primarily due to an increase in professional services fees to support Sarbanes-Oxley related compliance, as well as increase in headcount to support business growth. The decrease as a percentage of consolidated net revenue is due mainly to the significant increase in sales volume.

Operating Income (in thousands)

	December 31, 2004	% of Segment Net Revs.	December 31, 2003	% of Segment Net Revs.	Increase/ (Decrease)	Percent Change
Three Months Ended						
Publishing	$ 120,608	23%	$ 104,964	27%	$ 15,644	15%
Distribution	16,471	10%	11,997	10%	4,474	37%
Consolidated	$ 137,079	20%	$ 116,961	23%	$ 20,118	17%

Publishing operating income for the three months ended December 31, 2004 increased $15.6 million or 15% from the same period last year, from $105.0 million to $120.6 million while the percentage of operating income to segment revenues decreased from 27% to 23%. The decrease in the percentage of operating income to segment revenues is due mainly to increasing costs of sales due to higher intellectual property license and royalty costs discussed above. International publishing operating income for the three months ended December 31, 2004 benefited from the positive impact of the year-over-year strengthening of the EUR, AUD and the GBP in relation to the U.S. Dollar. Excluding the impact of changes in foreign currency rates, publishing operating income for the three months ended December 31, 2004 increased approximately $10.8 million from the same period last year. This increase is primarily due to:

Strong performance in both the domestic and international markets of our fiscal 2005 third quarter title releases.

Partially offset by:

Increased sales and marketing spending to support and extend the overall product life cycle of our big proposition titles.

Hand-Held (in thousands)

Distribution operating income for the three months ended December 31, 2004 increased by $4.5 million over the same period last year, from a $12.0 million to $16.5 million. Excluding the impact of changes in foreign currency rates, distribution operating income for the three months ended December 31, 2004 increased by approximately $3.1

million from the same period last year. This increase is primarily due to a shift in the mix of hardware versus software sales as software tends to be a higher margin business.

	December 31, 2004	% of Segment Net Revs.	December 31, 2003	% of Segment Net Revs.	Increase/ (Decrease)	Percent Change
Nine Months Ended						
Publishing	$ 168,111	18%	$ 93,240	16%	$ 74,871	80%
Distribution	19,359	7%	11,934	6%	7,425	62%
Consolidated	$ 187,470	16%	$ 105,174	13%	$ 82,296	78%

Publishing operating income for the nine months ended December 31, 2004 increased $74.9 million from the same period last year, from $93.2 million to $168.1 million. International publishing operating income for the nine months ended December 31, 2004 benefited from the positive impact of the year-over-year strengthening of the EUR, AUD and the GBP in relation to the U.S. dollar. Excluding the impact of changes in foreign currency rates, publishing operating income for the nine months ended December 31, 2004 increased approximately $64.2 million from the same period last year. This increase is primarily due to:

Strong performance in both the domestic and international markets of our fiscal 2005 title releases.

Partially offset by:

Increased sales and marketing spending to support and extend the overall product life cycle of our big proposition titles.

Distribution operating income for the nine months ended December 31, 2004 increased $7.4 million over the same period last year, from $11.9 million to $19.4 million. Excluding the impact of changes in foreign currency rates, distribution operating income for the nine months ended December 31, 2004 increased by $5.8 million from the same period last year. This increase is primarily due to a shift in the mix of hardware versus software sales as software tends to be a higher margin business.

Investment Income, Net *(in thousands)*

	December 31, 2004	% of Consolidated Net Revenue	December 31, 2003	% of Consolidated Net Revenue	Increase/ (Decrease)	Percent Change
Three Months Ended	$ 3,197	%	$ 1,464	%	$ 1,733	118%
Nine Months Ended	7,954	%	4,125	1%	3,829	93%

Investment income, net for the three months ended December 31, 2004 was $3.2 million as compared to $1.5 million for the three months ended December 31, 2003. The increase was primarily due to higher invested balances combined with rising yields during the three months ended December 31, 2004 as compared to the three months ended December 31, 2003.

Investment income, net for the nine months ended December 31, 2004 increased $3.8 million from $4.1 million for the nine months ended December 31, 2003 as compared to $8.0 million for the nine months ended December 31, 2004. The increase was primarily due to higher invested balances combined with rising yields during the nine months ended December 31, 2004 as compared to the nine months ended December 31, 2003 and a realized gain in the second quarter of fiscal 2005 of $0.5 million on the partial sale of an investment in common stock.

Provision for Income Taxes (in thousands)

	December 31, 2004	% of Pretax Income	December 31, 2003	% of Pretax Income	Increase/ (Decrease)	Percent Change
Three Months Ended	$ 43,014	31%	$ 41,444	35%	$ 1,570	4%
Nine Months Ended	60,662	31%	38,248	35%	22,414	59%

The income tax provision of $43.0 million and $60.7 million for the three months and nine months ended December 31, 2004, respectively, reflects our effective income tax rate of 31%. The significant items that generated the variance between our effective rate and our statutory rate of 35% were research and development tax credits and the impact of foreign tax rate differentials, offset by an increase in state taxes. The realization of deferred tax assets depends primarily on the generation of future taxable income. We believe that it is more likely than not that we will generate taxable income sufficient to realize the benefit of net deferred tax assets recognized.

Liquidity and Capital Resources

Sources of Liquidity

(in thousands)

	December 31, 2004	March 31, 2004	Increase/ (Decrease)
Cash and cash equivalents	$ 402,530	$ 466,552	$ (64,022)
Short-term investments	310,650	121,097	189,553
	$ 713,180	$ 587,649	$ 125,531
Percentage of total assets	53%	61%	

	For the nine months ended December 31, 2004	For the nine months ended December 31, 2003	Increase/ (Decrease)
Cash flows provided by operating activities	$ 96,378	$ 46,334	$ 50,044
Cash flows used in investing activities	(198,291)	(17,857)	(180,434)
Cash flows provided by financing activities	30,134	102,475	(72,341)

As of December 31, 2004, our primary source of liquidity is comprised of $402.5 million of cash and cash equivalents and $310.7 million of short-term investments. We believe that we have sufficient working capital ($900.9 million at December 31, 2004), as well as funds available from our international credit facilities, to finance our operational requirements for at least the next twelve months, including purchases of inventory and equipment, the funding of the development, production, marketing and sale of new products and the acquisition of intellectual property rights for future products.

We actively manage our capital structure as a component of our overall business strategy. When we determine that market conditions are appropriate, we may seek to achieve long-term value for the shareholders through, among other things, new debt or equity financings or refinancings, share repurchases and other transactions involving our equity or debt securities.

Cash Flows

Cash and cash equivalents were $402.5 million at December 31, 2004 compared to $466.6 million at March 31, 2004. Activity in cash and cash equivalents for the nine months ended December 31, 2004 included $96.4 million provided by operating activities, $198.3 million used in investing activities, and $30.1 million provided by financing activities. The primary drivers of operating cash flows were net income generated by increased sales volume adjusted for amortization of capitalized software development costs and intellectual property licenses for titles released in the first nine months of fiscal 2005. This was offset by increased accounts receivable and inventories at the end of the nine months and continued investment in software development and intellectual property rights. The increase in accounts receivable and inventories was due to high sales volume related to holiday sales and build up of inventory to support that sales volume. In the nine months ended December 31, 2004, we spent approximately $96.9 million in connection with the development and acquisition of publishing or distribution rights for products being developed by third parties and the execution of new license agreements granting us long-term rights to intellectual property of third parties, as well as incurrence of product development costs relating to internally developed products.

We expect that we will continue to make significant expenditures relating to our investment in software development and intellectual property licenses. Our future cash commitments relating to these investments are detailed below in Commitments. Cash flows from operations are affected by our ability to release highly successful titles. Though many of these titles have substantial production or acquisition costs and marketing budgets, once a title recoups these costs, incremental net revenues typically will directly and positively impact cash flows. We currently expect that a primary source of future liquidity, both short-term and long-term, will be our current cash and short-term investments combined with cash flows from continuing operations.

For the nine months ended December 31, 2004, cash flows used in investing activities were principally due to the purchase of short-term investments. Cash provided by financing activities for the same period is the result of the issuance of common stock related to employee stock option and stock purchase plans.

Key Balance Sheet Accounts

Accounts Receivable

(amounts in thousands)	**December 31, 2004**	**March 31, 2004**	**Increase/ (Decrease)**
Gross accounts receivable	$ 428,103	$ 109,605	$ 318,498
Net accounts receivable	344,894	62,577	282,317

The increase in gross accounts receivable was primarily the result of increased sales volume related to December holiday sales. Significant shipments were made to customers in November and December and the related receivables were not due prior to quarter end.

Reserves for returns and price protection as a percentage of gross accounts receivable declined from 43% as of March 31, 2004 to 19% as of December 31, 2004. Reserves for returns and price protection are a function of the number of units and pricing of titles in retail inventory (see description of *Allowances for Returns, Price Protection, Doubtful Accounts and Inventory Obsolescence* in Item 2: Critical Accounting Policies). The decrease in reserves for returns and price protection as a percentage of receivables reflects the fact that there were no new releases and slower catalog sales in the fourth quarter of fiscal 2004. This compares to the big proposition new releases in the second and third quarters of fiscal 2005 which continue to experience strong sell through rates and thus require lower reserves. Catalog titles typically have a higher reserve as a percentage of accounts receivable compared to new releases as they are later in their life cycle and at a reduced selling price.

Inventories

(amounts in thousands)	December 31, 2004	March 31, 2004	Increase/ (Decrease)
Inventories	$ 41,656	$ 26,427	$ 15,229

The increase in inventories was primarily the result of the build up of Publishing inventory balances to support increased sales volume.

Software Development and Intellectual Property Licenses

(amounts in thousands)	December 31, 2004	March 31, 2004	Increase/ (Decrease)
Software development and intellectual property licenses	$ 106,466	$ 135,201	$ (28,735)

Software development and intellectual property licenses decreased from $135.2 million at March 31, 2004 to $106.5 million at December 31, 2004. The decrease is a result of :

$125.7 million of amortization of capitalized software development costs and intellectual property licenses reflecting the release of several big proposition titles during fiscal 2005 with associated large capitalized software development and intellectual property licenses. This includes releases of *Call of Duty: Finest Hour, THUG 2, X-Men Legends, Spider-Man 2, Shark Tale, Lemony Snicket s A Series of Unfortunate Events,* and *Rome: Total War.*

Offset by:

Continued investment in software development and intellectual property licenses. We capitalized approximately $96.9 million in the nine months ended December 31, 2004 in connection with the development and acquisition of publishing or distribution rights for products being developed by third parties, the execution of new license agreements granting us long-term rights to intellectual property of third parties, as well as the capitalization of product development costs relating to internally developed products.

Accounts Payable

(amounts in thousands)	December 31, 2004	March 31, 2004	Increase/ (Decrease)
Accounts payable	$ 156,376	$ 72,874	$ 83,502

The increase in accounts payable was primarily the result of increased inventory purchases by our publishing business to support the increased holiday sales volume.

Accrued Expenses

(amounts in thousands)	December 31, 2004	March 31, 2004	Increase/ (Decrease)
Accrued expenses	$ 155,057	$ 63,205	$ 91,852

The increase in accrued expenses was primarily driven by increases in accrued royalties due to strong sales on titles released in the third quarter of fiscal 2005, increases in marketing and coop accruals to support our third quarter titles, and an increase for compensation costs and other expenses.

Credit Facilities

We have revolving credit facilities with our Centresoft subsidiary located in the UK (the UK Facility) and our NBG subsidiary located in Germany (the German Facility). The UK Facility provides Centresoft with the ability to borrow up to GBP 8.0 million ($15.4 million), including issuing letters of credit, on a revolving basis as of December 31, 2004. Furthermore, under the UK Facility, Centresoft provided a GBP 0.6 million ($1.2 million) guarantee for the benefit of our CD Contact subsidiary as of December 31, 2004. The UK Facility bore interest at LIBOR plus 2.0% as of December 31, 2004, is collateralized by substantially all of the assets of the subsidiary and expires in November 2005. The UK Facility also contains various covenants that require the subsidiary to maintain specified financial ratios related to, among other things, fixed charges. As of December 31, 2004, we were in compliance with these covenants. No borrowings were outstanding against the UK Facility as of December 31, 2004. The German Facility provided for revolving loans up to EUR 0.5 million ($0.7 million) as of December 31, 2004, bore interest at a Eurocurrency rate plus 2.5%, is collateralized by certain of the subsidiary s property and equipment and has no expiration date. No borrowings were outstanding under the German Facility as of December 31, 2004.

Commitments

In the normal course of business, we enter into contractual arrangements with third parties for the development of products, as well as for the rights to intellectual property. Under these agreements, we commit to provide specified payments to a developer or intellectual property holder, based upon contractual arrangements. Typically, the payments to third-party developers are conditioned upon the achievement by the developers of contractually specified development milestones. These payments to third-party developers and intellectual property holders typically are deemed to be advances and are recoupable against future royalties earned by the developer or intellectual property holder based on the sale of the related game. Additionally, in connection with certain intellectual property rights acquisitions and development agreements, we will commit to spend specified amounts for marketing support for the related game(s) which is to be developed or in which the intellectual property will be utilized. Assuming all contractual provisions are met, the total future minimum commitments for these and other contractual arrangements in place as of December 31, 2004, are scheduled to be paid as follows (amounts in thousands):

	Contractual Obligations			
Fiscal year ending March 31,	Facility Leases	Developer and IP	Marketing	Total
2005	$ 3,053	$ 18,163	$ 1,000	$ 22,216
2006	11,028	24,226	13,949	49,203
2007	10,282	7,975	5,000	23,257
2008	7,468	5,775	5,000	18,243
2009	6,671	2,900		9,571
Thereafter	31,412			31,412
Total	$ 69,914	$ 59,039	$ 24,949	$ 153,902

The developer and intellectual property commitments above exclude approximately $9.3 million of commitments originally scheduled to be paid between fiscal 2004 through fiscal 2007 relating to an intellectual property rights agreement with a third party. Effective June 30, 2003, we terminated the agreement and filed a breach of contract suit against the third party.

Financial Disclosure

We maintain internal controls over financial reporting, which generally include those controls relating to the preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America. We also are focused on our disclosure controls and procedures, which, as defined by the Securities and Exchange Commission, are generally those controls and procedures designed to ensure that financial and non-financial information required to be disclosed in our reports filed with the Securities and Exchange Commission is reported within the time periods specified in the Securities and Exchange Commission s rules and forms, and that such information is communicated to management, including our chief executive officer and our chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Our Disclosure Committee, which operates under the Board-approved Disclosure Committee Charter and Disclosure Controls & Procedures Policy, includes senior management representatives and assists executive management in its oversight of the accuracy and timeliness of our disclosures, as well as in implementing and evaluating our overall disclosure process. As part of our disclosure process, senior finance and operational representatives from all of our corporate divisions and business units prepare quarterly reports regarding their current quarter operational performance, future trends, subsequent events, internal controls, changes in internal controls and other accounting and disclosure-relevant information. These quarterly reports are reviewed by certain key corporate finance representatives. These corporate finance representatives also conduct quarterly interviews on a rotating basis with the preparers of selected quarterly reports. The results of the quarterly reports and related interviews are reviewed by the Disclosure Committee. Finance representatives also conduct reviews with our senior management team, our external counsel and other appropriate personnel involved in the disclosure process, as appropriate. Additionally, senior finance and operational representatives provide internal certifications regarding the accuracy of information they provide that is utilized in the preparation of our periodic public reports filed with the Securities and Exchange Commission. Financial results and other financial information also are reviewed with the Audit Committee of the Board of Directors on a quarterly basis. As required by applicable regulatory requirements, the Principal Executive Officers and the Chief Financial Officer review and make various certifications regarding the accuracy of our periodic public reports filed with the Securities and Exchange Commission, our disclosure controls and procedures, and our internal controls over financial reporting. With the assistance of the Disclosure Committee, we will continue to assess and monitor our disclosure controls and procedures, and our internal controls over financial reporting, and will make refinements as necessary.

Recently Issued Accounting Standards and Laws

On December 15, 2004, the Financial Accounting Standards Board (FASB) released its final revised standard entitled FASB Statement No. 123R, *Share-Based Payment* (SFAS No. 123R). SFAS No. 123R requires that a public entity measure the cost of equity based service awards based on the grant date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award or the requisite service period. SFAS No. 123R is effective as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. We are currently assessing the impact SFAS No. 123R will have on our financial position and results of operations.

On November 24, 2004, the FASB issued Statement No. 151, *Inventory Costs, an Amendment of ARB No. 43, Chapter 4* (SFAS No. 151). The standard requires that abnormal amounts of idle capacity and spoilage costs within inventory should be excluded from the cost of inventory and expensed when incurred. The provisions of SFAS No. 151 are applicable to inventory costs incurred during fiscal years beginning after June 15, 2005. The Company expects the adoption of SFAS No. 151 will not have a material impact on our financial position or results of operations.

On December 15, 2004 the FASB issued Statement No. 153 (SFAS No. 153), *Exchanges of Nonmonetary Assets an Amendment of Accounting Principles Board Opinion No. 29*. This standard requires exchanges of productive assets to be accounted for at fair value, rather than at carryover basis, unless (1) neither the asset received nor the asset surrendered has a fair value that is determinable within reasonable limits or (2) the transactions lack commercial substance. The new standard is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The Company expects the adoption of SFAS No. 153 will not have a material impact on our financial position or results of operations.

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On October 22, 2004, the President signed the American Jobs Creation Act of 2004 (the Act). The Act raises a number of issues with respect to accounting for income taxes. For companies that pay U.S. income taxes on manufacturing activities in the U.S., the Act provides a deduction from taxable income equal to a stipulated percentage of qualified income from domestic production activities. The manufacturing deduction provided by the Act replaces the extraterritorial income (ETI) deduction currently in place. We currently derive benefits from the ETI exclusion which was repealed by the Act. Our exclusion for fiscal 2005, 2006, and 2007 will be limited to 95%, 75%, and 45% of the otherwise allowable exclusion and no exclusion will be available in fiscal 2008 and thereafter. The Act also creates a temporary incentive for U.S. multinationals to repatriate accumulated income earned abroad by providing an 85 percent dividends received deduction for certain dividends from controlled foreign corporations. The deduction is subject to a number of limitations. The Act also provides for other changes in tax law that will affect a variety of taxpayers. On December 21, 2004, the Financial Accounting Standards Board (FASB) issued two FASB Staff Positions (FSP) regarding the accounting implications of the Act related to (1) the deduction for qualified domestic production activities and (2) the one-time tax benefit for the repatriation of foreign earnings. The FASB decided that the deduction for qualified domestic production activities should be accounted for as a special deduction under FASB Statement No. 109, *Accounting for Income Taxes*. The FASB also confirmed, that upon deciding that some amount of earnings will be repatriated, a company must record in that period the associated tax liability. The guidance in the FSPs applies to financial statements for periods ending after the date the Act was enacted. We are evaluating the Act at this time and have not yet determined whether we will avail ourselves of this opportunity. We plan to complete our assessment before the end of fiscal 2006 and are not currently in a position to estimate a range of possible repatriation amounts.

Inflation

Our management currently believes that inflation has not had a material impact on continuing operations.

Factors Affecting Future Performance

In connection with the Private Securities Litigation Reform Act of 1995 (the Litigation Reform Act), we have disclosed certain cautionary information to be used in connection with written materials (including this Quarterly Report on Form 10-Q) and oral statements made by or on behalf of our employees and representatives that may contain forward-looking statements within the meaning of the Litigation Reform Act. Such statements consist of any statement other than a recitation of historical fact and can be identified by the use of forward-looking terminology such as may, expect, anticipate, estimate or continue or the negative thereof or other variations thereon or comparable terminology. The liste or reader is cautioned that all forward-looking statements are necessarily speculative and there are numerous risks and uncertainties that could cause actual events or results to differ materially from those referred to in such forward-looking statements. For a discussion that highlights some of the more important risks identified by management, but which should not be assumed to be the only factors that could affect future performance, see our Annual Report on Form 10-K for the fiscal year ended March 31, 2004 which is incorporated herein by reference. The reader or listener is cautioned that we do not have a policy of updating or revising forward-looking statements and thus he or she should not assume that silence by management over time means that actual events are bearing out as estimated in such forward-looking statements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the potential loss arising from fluctuations in market rates and prices. Our market risk exposures primarily include fluctuations in interest rates, foreign currency exchange rates and market prices. Our market risk sensitive instruments are classified as other than trading. Our views on market risk are not necessarily indicative of actual results that may occur and do not represent the maximum possible gains and losses that may occur, since actual gains and losses will differ from those estimated, based upon actual fluctuations in interest rates, foreign currency exchange rates and market prices and the timing of transactions.

<u>Interest Rate Risk</u>

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We do not use derivative financial instruments in our investment portfolio. We manage our interest rate risk by maintaining an investment portfolio consisting primarily of debt instruments with high credit quality and relatively short average maturities. We also manage our interest rate risk by maintaining sufficient cash and cash equivalent balances such that we are typically able to hold our investments to maturity. As of December 31, 2004, our cash equivalents and short-term investments included debt securities of $419.6 million.

Item 3. Quantitative and Qualitative Disclosures about Market Risk 67

The following table presents the amounts and related weighted average interest rates of our investment portfolio as of December 31, 2004 (amounts in thousands):

	Average Interest Rate	Amortized Cost	Fair Value
Cash equivalents:			
Fixed rate	2.29%	$ 110,239	$ 110,239
Variable rate	2.16%	90,362	90,362
Short-term investments:			
Fixed rate	2.28%	$ 311,565	$ 309,379

Our short-term investments generally mature between three and thirty months.

Foreign Currency Exchange Rate Risk

We transact business in many different foreign currencies and may be exposed to financial market risk resulting from fluctuations in foreign currency exchange rates, particularly GBP and EUR. The volatility of GBP and EUR (and all other applicable currencies) will be monitored frequently throughout the coming year. When appropriate, we enter into hedging transactions in order to mitigate our risk from foreign currency fluctuations. We will continue to use hedging programs in the future and may use currency forward contracts, currency options and/or other derivative financial instruments commonly utilized to reduce financial market risks if it is determined that such hedging activities are appropriate to reduce risk. We do not hold or purchase any foreign currency contracts for trading purposes. As of December 31, 2004, there were no hedging contracts outstanding.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, our management conducted an evaluation, under the supervision and with the participation of the principal executive officers and principal financial officer, of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act). Based on this evaluation, the principal executive officers and principal financial officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures are effective. Notwithstanding the foregoing, a control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that it will detect or uncover failures within Activision to disclose material information otherwise required to be set forth in our periodic reports.

Changes in Internal Controls

There was no change in our internal controls over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during our most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

On March 5, 2004, a class action lawsuit was filed against us and certain of our current and former officers and directors. The complaint, which asserts claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 based on allegations that our revenues and assets were overstated during the period between February 1, 2001 and December 17, 2002, was filed in the United States District Court, Central District of California by the Construction Industry and Carpenters Joint Pension Trust for Southern Nevada purporting to represent a class of purchasers of Activision stock. Five additional purported class actions have subsequently been filed by Gianni Angeloni, Christopher Hinton, Stephen Anish, the Alaska Electrical Pension Fund, and Joseph A. Romans asserting similar claims. Five of the six actions have been transferred to the same court where the first-filed complaint was pending. In addition, on March 12, 2004, a shareholder derivative lawsuit was filed, which in large measure asserts the same claims set forth in the federal class action lawsuit. That complaint was filed in Superior Court for the County of Los Angeles. We strongly deny these allegations and will vigorously defend these cases.

On July 11, 2003, we were informed by the staff of the Securities and Exchange Commission that the Securities and Exchange Commission has commenced a non-public formal investigation captioned In the Matter of Certain Video Game Manufacturers and Distributors. The investigation appears to be focused on certain accounting practices common to the interactive entertainment industry, with specific emphasis on revenue recognition. In connection with this inquiry, the Securities and Exchange Commission submitted to us a request for information. We responded to this inquiry on September 2, 2003. To date, we have not received a request from the Securities and Exchange Commission for any additional information. The Securities and Exchange Commission staff also informed us that other companies in the video game industry received similar requests for information. The Securities and Exchange Commission has advised us that this request for information should not be construed as an indication from the Securities and Exchange Commission or its staff that any violation of the law has occurred, nor should it reflect negatively on any person, entity or security. We have cooperated and intend to continue to cooperate fully with the Securities and Exchange Commission in the conduct of this inquiry.

On June 30, 2003, we terminated our Star Trek Merchandising License Agreement with Viacom Consumer Products, Inc. and filed a complaint in the Superior Court of the State of California for breach of contract and constructive trust against Viacom Consumer Products and Viacom International, Inc. (Viacom). On August 15, 2003, Viacom filed its response to our complaint as well as a cross-complaint alleging, among other matters, a breach of contract by Activision and seeking claimed damages in excess of $50 million. We strongly dispute the claims by Viacom, consider the damages alleged by Viacom to be speculative and without merit, and intend to defend vigorously and aggressively against the cross-complaint.

In addition, we are party to other routine claims and suits brought by us and against us in the ordinary course of business, including disputes arising over the ownership of intellectual property rights, contractual claims and collection matters. In the opinion of management, after consultation with legal counsel, the outcome of such routine claims will not have a material adverse effect on our business, financial condition, results of operations or liquidity.

Item 5. Other Information

On September 21, 2004, the Company s Board of Directors unanimously resolved, in light of the added regulatory burdens imposed on outside directors by the Sarbanes Oxley Act of 2002, (1) to increase, from $25,000 to $30,000, the annual retainer for outside directors; (2) to increase, from $2,500 to $5,000, the annual compensation for serving as chairman of either the Compensation Committee or the Nominating and Corporate Governance Committee; (3) to increase, from $2,500 to $10,000, the annual compensation for serving as chairman of the Audit Committee; (4) to increase, from $2,500 to $5,000, the annual compensation for serving as a member of the Audit Committee. The resolutions adopted by the Board of Directors were effective as of September 21, 2004.

Item 6. Exhibits

(a) Exhibits

3.1	Amended and Restated Certificate of Incorporation, dated June 1, 2000 (incorporated by reference to Exhibit 2.5 of our Current Report on Form 8-K, filed on June 16, 2000).
3.2	Certificate of Amendment of Amended and Restated Certificate of Incorporation, dated June 9, 2000 (incorporated by reference to Exhibit 2.7 of our Current Report on Form 8-K, filed on June 16, 2000).
3.3	Certificate of Amendment of Amended and Restated Certificate of Incorporation, dated August 23, 2001 (incorporated by reference to Exhibit 3.3 of Amendment No. 1 to our Registration Statement on Form S-3, Registration No. 333-66280, filed on August 31, 2001).
3.4	Certificate of Designation of Series A Junior Preferred Stock, dated December 27, 2001 (incorporated by reference to Exhibit 3.4 of our Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2001).

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3.5	Amended and Restated By-laws dated August 1, 2000 (incorporated by reference to Exhibit 3.2 of our Current Report on Form 8-K, filed July 11, 2001).
4.1	Rights Agreement dated as of April 18, 2000, between us and Continental Stock Transfer & Trust Company, which includes as exhibits the form of Right Certificates as Exhibit A, the Summary of Rights to Purchase Series A Junior Preferred Stock as Exhibit B and the form of Certificate of Designation of Series A Junior Preferred Stock of Activision as Exhibit C (incorporated by reference to our Registration Statement on Form 8-A, Registration No. 001-15839, filed April 19, 2000).
31.1	Certification of Robert A. Kotick pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Ronald Doornink pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.3	Certification of William J. Chardavoyne pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Robert A. Kotick pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Ronald Doornink pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.3	Certification of William J. Chardavoyne pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: February 8, 2005

ACTIVISION, INC.

/s/ William J. Chardavoyne
William J. Chardavoyne
Executive Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)